

# FINANCE AND FINANCIAL POLICY IN DEFENCE CONTINGENCIES

## DECLARATION

PAUL LEE

A sub-thesis submitted in partial fulfilment of the requirements for the degree of Master of Arts (Strategic Studies) in the Strategic and Defence Studies Centre, Research School of Pacific Studies, The Australian National University.

The views expressed in this sub-thesis are entirely the considered opinion of the author and are in no way to be construed as representing either Government or Defence policy.

1989



Paul Lee

Canberra, June 1989

## ACKNOWLEDGEMENTS

### DECLARATION

I gratefully acknowledge the understanding and guidance of my supervisor, Dr Ross Sahlberg of the Strategic and Defence Studies Centre, without whose helpful and encouraging suggestions and supervision this sub-thesis would not have come into being in its present form.

I am also grateful to Dr George Chessman of the Peace Studies Centre, for his assistance in and providing very useful advice on aspects of this sub-thesis.

This sub-thesis is my own work and all sources used have been acknowledged. The views expressed in this sub-thesis are entirely the considered opinion of the author and can in no way be construed as representing either Government or Defence policy.

My sincere thanks go to Russell whose co-operation and time facilitated the research and eased the pain of doing this sub-thesis.

My sincere gratitude must go to Ms Joanne Crawford, who spent a very extensive period of time proofing, correcting, questioning and improving the content, style and structure of this sub-thesis that without her credit and strengths of it must be due to her. The faults are entirely my own.

Paul Lee

Canberra, June 1989



# TABLE OF CONTENTS

## INTRODUCTION

## CHAPTER 1: THE THEORY AND EXPERIENCE OF WAR FINANCE

1. Introduction	6
2. War Finance	6
3. Adam Smith	9
4. David Ricardo	11
5. The 19th Century	14
6. <b>ACKNOWLEDGEMENTS</b>	17
7. Lord Lionel Robbins	21
8. Conclusion	23

## CHAPTER 2: FINANCIAL MANAGEMENT OF LIMITED CONFLICT

I gratefully acknowledge the understanding and guidance of my supervisor, Dr Ross Babbage of the Strategic and Defence Studies Centre, without whose helpful and encouraging suggestions and supervision this sub-thesis would not have come into being in its present form.

## CHAPTER 3: COSTS OF WAR

I am also grateful to Dr Graeme Cheeseman of the Peace Research Centre and Mr Mike Ives of the Department of Defence for reading, commenting on and providing very useful advice on aspects of this sub-thesis.

Thanks should also be paid to the staff of the Defence Library system at Russell whose co-operation and time facilitated the research and eased the pain of doing this sub-thesis.

My special gratitude must go to Ms Joanne Crawford, who spent such an extensive period of time proofing, correcting, questioning and improving the content, style and structure of this sub-thesis that much of the credit and strengths of it must be due to her. The faults are entirely my own.

## CHAPTER 4: FINANCIAL POLICY AND DEFENCE CONTINGENCIES

1. Introduction	61
2. Defence Contingency	64
3. Financial Aspects of a Defence Contingency	64
4. Role of the Reserve Bank	65
5. Escalated Low Level Contingency	73
6. Role of Treasury	77
7. More Substantial Conflict	78
8. Mobilisation	81
9. Role of Defence and Government	83
10. An Indication of Costs	84
11. Conclusion	85

## CONCLUSION

## BIBLIOGRAPHY

# TABLE OF CONTENTS

INTRODUCTION	1
CHAPTER 1: THE THEORY AND EXPERIENCE OF WAR FINANCE	6
1. Introduction	6
2. War Finance	6
3. Adam Smith	9
4. David Ricardo	11
5. The 19th Century	14
6. John Maynard Keynes	17
7. Lord Lionel Robbins	21
8. Conclusion	23
CHAPTER 2: FINANCIAL MANAGEMENT OF LIMITED CONFLICT	25
1. The USA's Experience in Vietnam	25
2. Australia in Vietnam	28
3. Argentina and the Malvinas Conflict, 1982	31
4. The MX Missile Crisis, 1985	35
CHAPTER 3: COSTS OF WAR	40
1. Introduction	40
2. Peacetime Defence	40
3. Limited War - The USA in Vietnam	41
4. Conventional War - Iran/Iraq	43
5. Limited War - The Falklands War	45
6. Australia - Exercise Kangaroo 89	49
CHAPTER 4: AUSTRALIA - WAR AND CONTINGENCY FINANCE	51
1. Introduction	51
2. World War 1	52
3. World War 2	55
4. Applicability of Total War Experience to the Present	57
5. Planning for the Next War	59
(a) The War Book	59
(b) Defence Contingency Planning	60
CHAPTER 5: FINANCE, FINANCIAL POLICY AND DEFENCE CONTINGENCIES	64
1. Introduction	64
2. Defence Contingency	64
3. Financial Aspects of a Defence Contingency	64
4. Role of the Reserve Bank	68
5. Escalated Low Level Contingency	73
6. Role of Treasury	77
7. More Substantial Conflict	78
8. Mobilisation	81
9. Role of Defence and Government	83
10. An Indication of Costs	84
11. Conclusion	86
CONCLUSION	87
BIBLIOGRAPHY	90

## INTRODUCTION

This thesis is concerned with the financial policy instruments and institutional mechanisms involved in Australian defence policy and which are readily available to the government for it to meet its security objectives. In addition, the thesis addresses the nature of financial responses when Australian defence policy is disturbed by events of a military, strategic or national security nature. The political and strategic issues which give rise to these events are not discussed.

Attention is concentrated on the role of key institutions; the appropriateness of current financial policies in relation to the scale, intensity and duration of military conflict; and the financial consequences (normally measured as costs - see Chapter 3) of engaging in military activities. Borrowing from Lord Lionel Robbins and discussed further in Chapter 1, the thesis aims to "...afford insights into the physiology of the body economic in conditions of unusual strain."<sup>1</sup>

This paper avoids intentionally the wider field of defence economics<sup>2</sup>. That discipline has little relevance to aspects of operational financial policy, its adjustment and management in a defence emergency, and decision-making based on it and other critical, strategic factors. Other structural and economic forces which affect Australia nationally in the normal course of events (eg. tariffs, subsidies, dumping etc.) are also marginal to this thesis. They are addressed only in so far as they might affect these financial mechanisms and policies.

---

1. Lord Robbins, *The Economic Problem in Peace and War*, Macmillan and Co. Ltd., London, 1950, p.2

2. Most books on peacetime defence economics include significant sections on matters such as procurement, the military-industrial complex, planning and budgeting etc. In a defence contingency, there might be other economic side-effects on the community. These would likely include such factors as increased defence-related production, labour costs and competition for skilled personnel, increased costs for state and local governments especially those within possible areas of operations, and effects on trade. However, these topics themselves would each occupy an entire paper and attempts to treat them in a thesis focussing on finance and financial policy would do scant justice to them or the topic at hand.



In Australia, the historic background to the funding of war-related defence activities can be located in the experience of current institutions, such as the Treasury and the Commonwealth and Reserve Banks, in moulding policies and evolving methods for dealing with the older rubric of "war finance" (see Chapter 4).

War finance is a general title that covers the manifold responsibilities assumed by various authorities in guiding and managing the resources of the nation during "...a great change from peace-time experience"<sup>3</sup> - that is, in facing "the economic consequences of war". It is a concept rooted in experience. Its definition is self-evident but its methods are as complex as the apparatus of the state which it serves. It owes as much to the observable methods of government practice in responding to either periodic economic stresses or a past crisis induced by a major war as it does to academic or theoretical constructs. Nonetheless, there is a small body of economic literature within which the evolution of institutional practices must be located. Chapter 1 examines the classic theoretical offerings available on the subject of war finance but illustrates that these theories are derived from observed experience by individuals of very practical affairs.

War finance originated in the crises of funding past wars. It has been one of the outgrowths of the developing institutions of the modern state, and has complex ties with the institutions and policies of the international economic arena. In the late 20th Century, the practice and purpose of financing wars would generally accord with a "realist" (as opposed to "idealist") persuasion in international relations. The realist perspective has the following general characteristics:

- \* It is state-centric.
- \* It views financial mechanisms (eg. aid policy, freezes, blockades) as intrinsic tools of state policy.

3. J.M.Keynes, *How to Pay for the War*, Macmillan and Co.Ltd., 1940, p.4.

\* It assumes that the international order, in both its political and economic dimensions, is ultimately anarchic, turbulent and uncertain - war constitutes an intensification of these features.

\* It views the role of finance/economics in neo-mercantilist terms<sup>4</sup>. In this role, war finance underlines the military and other security instruments of the state. It may also be the driving engine of government action in pursuing its other policies.

\* Despite the ultimate turbulence of the world order, there are sufficient international economic institutions and mechanisms in place (eg. the IMF, World Bank, the private international banking system as a whole) that will fund, underpin, or pervade the waging of war in a fairly predictable manner.

As modern realism takes on its late 20th century economic guise<sup>5</sup>, war finance assumes an implicit relationship between security and wealth.<sup>6</sup> The realist view of the global political environment maintains that self-interest remains the enduring motif of the modern state and that national security (be it economic or military) is the means for achieving that goal. Whether security continues to be defined militarily, or whether recent neo-mercantilist tendencies succeed in asserting the primacy of economic policy as an instrument of national struggle, it remains a fact that finance must underwrite any deliberate government security policy. War finance grows out of this fact.

4. Mercantilism refers to trading practices prevalent in Europe in the 16-18th centuries. In brief, imports were bad (outflow of gold) and exports were good (inflow of gold); tariffs and bounties were policy instruments for achieving these ends. It was opposed in principle by Adam Smith, except with regard to national security. Neo-mercantilism gained headway after the Great Depression, when governments designed policies to protect domestic industries from full overseas competition and/or to encourage exports at the expense of other overseas exporters or the domestic industries of the importing nation. Neo-mercantilism regards a trade surplus, or a positive current account, as intrinsic to national security, and the balance of trade figures (which form the bulk of the current account) as the key measurement of this belief.

5. Richard A. Higgott, *The World Economic Order and Australia: Towards a Wider Definition of Security*, from the conference on Australia and the World, Prologue and Prospects, Australian National University, Canberra, 6-9 December 1988.

6. As if to reinforce the truth, and urgency, of this belief, *Time Magazine* has emphasised the economic basis of the Bush Administration's quest for security. Alice Rivlin, former head of the Congressional Budget Office, was quoted in the *Wall Street Journal* (cited in *Time*, 30 January 1989) as saying, "The budget deficit...has become a defense issue, a foreign policy issue..." and James Baker, the Secretary of State, is quoted later as recognizing (*Time*, 13 February 1989) "...the primacy of economic policy in the late 20th century."

Financial requirements are the common denominator across the several generic levels of defence contingencies which have received endorsement as planning tools for guiding defence activity. Low level contingency, as an accretion to current peacetime preparedness, occupies the opposite end of the spectrum from declared and total war. The latter, however, is the source of most of the experience and all of the theory of war finance, when its role has been to serve to mobilize the entire resources of the nation - as eventually undertaken in World War II.

Several defence economic generalisations need to be made to establish a framework for an understanding of the operation and limitations of war finance:

- \* Defence spending (of which, war finance is but a single component - and even then in unusual circumstances only) is a political issue as much an economic one, in the sense that the "...mediation of differing perceptions of need is worked out in a political process".<sup>7</sup>

- \* The level of defence expenditure is a function of a country's perception of the nature and extent of threats against it.

- \* The transition from peacetime expenditure to some level of defence contingency or war expenditure is independent of the baseline pattern of spending to date. What matters is the celerity of the transition and the co-ordination of the appropriate military strategy and financial policies.

The successful implementation of financial policy in underpinning a national response to a conflict will depend on several key variables, possibly independent of the actual level or trend of that conflict, and set out at length in Chapter 5:

- (a) The ability of Australia to control (or be perceived to control) the conflict, even in the event of escalation;
- (b) The reaction of the Australian Government to financing the conflict, be it by loans, deficit financing, taxation or internal reallocation of resources among the broad

7. Gavin Kennedy, *Defense Economics*, London, Duckworth and Co.Ltd., 1983, p2.



functions of government;<sup>8</sup>

(c) The reporting of the conflict by the media; and

(d) The expectations of financial markets (Keynes' "animal spirits") concerning the resolution of the conflict and the type of post-crisis environment in which Australia must continue to function.

Two important qualifications need to be placed on the role of finance in the discussion of defence emergencies. Firstly, a conflict which remains at a strategically defined low level does not guarantee that the reactions of markets, financial institutions and overseas investors will also be "low level". The MX missile crisis of early 1985 (a case study discussed in Chapter 2), an internal political affair, led to a crisis of confidence in Australia's "political" economy and a collapse in the value of the Australian dollar out of all apparent rational proportion to the affair itself. Secondly, a conflict which escalates or leads into more substantial conflict, or oscillates over an extended period of time, should not imply that financial requirements or responses will do the same. The financial community will adopt its own responses to the contingency, which may or may not accord with the response of the government.<sup>9</sup> The implications of this are discussed in Chapter 5.

In summary, finance (or war finance in its defence emergency role) is an instrument of state policy. It underpins and shapes the gamut of defence activity both in peacetime and during a strategic crisis of some dimension when the survival of the nation is not an issue.

8. These 10 functions being defence(9.6%), health(10.0%), education(7.0%), social welfare(27.4%), housing & community amenities(2.2%), culture & recreation(1.3%), general public services(7.1%), general economic services(5.5%), not allocated to function, which includes payment to the states(19.3%) and public debt interest(10.6%). The figures in brackets refer to achieved financial expenditure for 1986-87, as reported in Budget papers for the 1987-88 estimates.

9. A low level contingency, however defined or measured, could even adopt a form of normality where the element of crisis dissipates and increased military activity becomes part of the standard economic assessment of that country's well-being, part of its "risk-assessment".



## CHAPTER 1: THE THEORY AND EXPERIENCE OF WAR FINANCE

### 1. Introduction

The origin of a conceptual framework specifically addressing the financing of war lies with David Ricardo (although he built upon the insights of Adam Smith a generation before). Ricardo was responding to the series of economic crises brought on by the Napoleonic Wars. Apart from sundry observations made during the next century or so, the next original work produced on the methods of war finance came from J.M. Keynes. His response, like Ricardo's, arose as a reaction to war, to the injustices of the British domestic economic experience in the First World War. Keynes also sought to aid in preparation for planning expenditures (and this time around, equalizing the financial sacrifices) for the coming Second World War.

The writings of Lord Robbins, consequent to the Second World War, were, it will be argued, largely critical of Keynes' argument for the primacy of finance and were summary reflections of his own financial experience in the war. They were not seminal. They ratified the experience of total war, but were less relevant to the new age of limited wars (made almost essential by the alternative of nuclear annihilation) which did not challenge the primacy of economic policy in government considerations.

Therefore, Keynes is the authority for guiding financial policy in scenarios which do not rise above the low level, or which remain regional in their immediate strategic repercussions.

### 2. War Finance: Theory and Practice

The twentieth century Italian philosopher of history, Benedetto

1. C.S. Shoup (pp. 143-4) maintained that Ricardo was the first political economist to specifically address the problems of financing war. The two key sources were, a. the "Essay on the Funding System", 1819, and b. paragraphs 3-7 of Chapter XVII of Ricardo's most famous work, *On the Principles of Political Economy, and Taxation*, 1817; see Shoup, C.S., *Ricardo on Taxation*, Columbia University Press, New York, 1960, pp. 143-4, and especially Chapter XI, "War Finance", pp. 143-167.

Croce once remarked that "...all action is thought; and all thought is action". Allowing for a certain degree of literary aphorism, his statement encapsulated the notion that, in reality, there cannot be (and is not) a clear disjuncture between theory (thought) and practice (action). Implicit is the recognition that thought does not cease when activity commences; they co-exist.

In other words, theoretical assumptions underpin and pervade all activity. Theory constitutes a conceptual framework through which events are perceived and must themselves travel. In this sense, practical knowledge, policy and decision making are not possible in the absence of a theoretical framework. The way the world is perceived, and the way activity is pursued, are the results of theoretical assumptions and observed experience.

But this is not a thesis about theory, per se. Instead, the thesis draws on existing theoretical and historical insights in order to establish a framework within which financial policy making takes place. From these insights, it detects a set of basic principles on which subsequent policy developments (and specific case studies) might build.

In this thesis, then, theorising is understood as the literary record of solutions or explanations to historical dilemmas of raising war finance, and the attempt to draw from particular historical experience or observation some general principles. These insights are in turn modified by subsequent practice. In this sense, the relationship between theory and practice is an intimate and inseparable one.

This relationship between theory and practice is rendered more acute in the case of financial policy by the fact that the theories of raising war finance are the creations of individuals with extensive public experience (Ricardo was a banker, Keynes a Treasury official and author, Robbins an academic co-opted by the government for the duration of the Second World War, and Smith a teacher whose survival depended upon the quality of his lectures and writing), reflecting on the institutions and events

they witnessed around them. as the state continues to evolve, an accretion to their theories may need to be developed to reflect

The theories of war finance are few, and emerged from particular historical circumstances. Thus, while they provide a framework and range of insights for policy makers, they are to some extent restricted by the specific nature of the events which gave rise to them. It is for this reason that the experience of both policy making and institutional responses in recent conflicts must be examined alongside any exposition of the theory of war finance. Such conflicts diverge from the events which generated earlier theories and may require policy responses which are modifications of those suggested by existing theory. In addition, an examination of the policy direction and financial consequences associated with these conflicts provides a results background which may be used to generate new theoretical insights. The conflicts which are examined later in this thesis, as well as the discussions of contingency planning, are different in degree, in some cases substantially, from those which generated the theories discussed in this chapter. They are subjects of interest in particular for the ways in which the state and its institutions have both adopted and adapted (or failed to do so) existing theories in the light of changed circumstances. defence did not return revenues. Therefore he classified it as a necessary but unproductive activity. Being

The two broad options of taxation and borrowing were recognised by Adam Smith (and acknowledged in later events and by later authors) and endorsed by governments in the conduct of wars and conflicts. The accretion of variations on these two basic options (eg. in the nature and scale of the borrowings, or in the type of taxation imposed) are as much a reflection of the increasing complexity of the modern state as they might be the original theories of later commentators. Theory has endorsed experience but has rarely attempted to transcend it. eighteenth century industrial society.

The theories of war finance discussed in this thesis are the most prominent, coherent and accessible of existing opinions. They are few because the discipline does not lend itself to uniqueness, originality or disputationary heresy. Yet being empirical in method and belief, the theorists themselves would



be the first to admit, that as the state continues to evolve, an accretion to their theories may need to be developed to reflect the latest changes in technology at the disposal of the state, or the structures, policies and processes which drive it. None of the theories have applied universality, and it cannot be pretended that they would supply ready solutions to unique problems or crises which periodically beset the state.

### 3. Adam Smith

In the fifth book of *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Adam Smith addressed the implications of defence expenditure by the state and the necessity of raising sufficient revenue (as well as the results of not doing so) to finance the conduct of wars undertaken by the United Kingdom in his lifetime.

In Smith's opening words security was, "The first duty of the sovereign"<sup>2</sup>, which involved "protecting the society from the violence and invasion of other independent societies, [and] can be performed only by means of a military force". The two functions of the state in Smith's day were defence and justice. Unlike justice, defence did not return revenue. Therefore he classified it as a necessary but unproductive activity. Being unproductive it did not accumulate capital and did not generate an increase in the capital stock; it produced neither savings nor profit. Being necessary, and therefore a refutation to some extent of the *laissez-faire* economic principles set out in Books 1 and 2, and upon which his reputation rests, defence should then at least be conducted efficiently. The most useful instrument for executing the defence of the realm was a small professional army (not conscripts), which was itself a reflection of the division of labour increasingly evident in eighteenth century industrial society.

---

2. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Encyclopaedia Britannica Inc, Chicago, 1952, p.405; published in the "Great Books of the Western World", Vol 39. Smith rejected the mercantilist doctrine of national policy which sought to control the use of resources in such a way that ensured a continuing favourable balance of payments and created a self-supporting politico-economic unit. Nevertheless, in extreme circumstances of threat to national well-being, Smith was prepared to allow government intervention to protect the "invisible hand" of Books 1 and 2 of his *Magnum Opus*.

In examining the financing of the military establishment, Smith was concerned with two broad tendencies:

- (a) The increasing cost of defence and the conduct of war to the public finances<sup>3</sup>; and
- (b) The explosion of the national debt since 1694. The national debt was first created with the inception of the Bank of England, its immediate and intentional purpose being to finance the United Kingdom's wars with the France of Louis XIV.

There were two conceivable methods of financing wars in the eighteenth century:

- (1) By direct taxation; naturally this was unpopular and "...the more loudly the people complain of every new tax, the more difficult it becomes... either to find out new subjects of taxation, or to raise much higher the taxes already imposed upon the old"<sup>4</sup>.

Consequently recourse was had to:

- (2) Borrowing, "...a mortgage on the public's revenue"<sup>5</sup>.

Smith identified two types of borrowing:

- (a) Personal credit - a type of promissory note, short term, non-interest bearing, and tied to the object for which it was raised; and
- (b) Borrowing upon assignments:
  - (i) short term - where the principal and the interest were expected to be repaid; and
  - (ii) perpetuity - where only the interest was repaid in the short-term (ie. in the lender's lifetime). The principal might be refunded over 100 years or so and might be seen by the lender as a life-time investment in the well-being, and victory, of the state.

Smith was alarmed by the apparently unchecked growth of the national debt for his country's global imperial wars which of themselves ensured no adequate compensation or rate of return

3. "The great change introduced into the art of war by the invention of firearms, had enhanced still further both the expenses of exercising and disciplining any particular number of soldiers in time of peace, and that of employing them in time of war. Both their arms and ammunition have become more expensive. A musket is a more expensive machine than a javelin or a bow and arrow; a cannon or a mortar than a balista or a catapulta...". Cited in Gavin Kennedy, *Defense Economics*, London, Duckworth, 1983, p.8.

4. Smith, *Op. cit.*, p.408

5. *Ibid.*, p.404.

for their cost, even when successful (for example, he viewed colonisation as an economic "sink")<sup>6</sup>. Nonetheless, borrowing was inevitable given that the cost of wars far outweighed the annual and even accumulated revenue of the state and that wars, once commenced, were of unknown duration. In Smith's words,

...when war comes they [governments] are both unwilling and unable to increase their revenue in proportion to the increase of their expense. They were unwilling for fear of offending the people, who, by so great and so sudden an increase of taxes, would soon be disgusted with the war; and they are unable from not well knowing what taxes would be sufficient to produce the revenue wanted<sup>7</sup>.

Smith opposed borrowing to finance wars on the grounds of economic efficiency. It would prove much cheaper in the long run to finance wars on a "cash" or "fight as you earn" basis than it would be to borrow. Also the national debt was a century old and growing, and a new war would merely serve to add another layer of debt over existing ones, with a long-term detrimental impact on the productivity of the wealth-generating portion of the social system. However, he admitted that in time of war the principal aim of government was to "...relieve the present exigency.... The future liberation of the public's revenue they leave to the care of posterity"<sup>8</sup>.

#### 4. David Ricardo

From the time of Smith's writing *The Wealth of Nations* (1776) until his death in 1790 the national debt of England doubled to some 240 million pounds, due principally to the requirements of fighting the American War of Independence. As a result of the drawn-out Napoleonic Wars the national debt grew to 800 million pounds by 1815. In his *Essay on the Funding System*<sup>9</sup> David Ricardo, a London banker, expressed concern with the ways and means of funding this huge debt. Whereas Smith had approached the economics of defence more from an historical and moral

6 It was also morally bankrupt. To make war (ie. victory) "pay", meant the economic exploitation of territories captured during and retained after the war. This would eventually have a corrupting influence on his country. It is worth noting here that in his own lifetime Smith was renowned as a moral philosopher, and only posterity has lauded him as the founder of the discipline of political economics ("economics" was christened a hundred years later in Germany.)

7. Ibid., p.408.

8. Ibid., p.406.

9. This was written by Ricardo in 1819 for the *Encyclopaedia Britannica*.



context (particularly his survey of the past in Book 3), Ricardo emphasised the effects of war on the current social system, the disruption to the free flow of capital, effects on trade, the impact on productivity of the temporary demands of war and the like. But Ricardo and Smith were alike in two vital respects:

(a) in a choice between "opulence" and defence, both saw themselves as obliged to give defence the preference (Smith, for example, had supported the Navigation Acts which prohibited the use of foreign vessels for British and Colonial trade); and

(b) both recommended that governments should conduct their wars by current taxation, not by loans.

The necessity for increased taxation would be a restraining factor on the conduct of governments and the acquiescence of the population. Taxation would affect the present and loans the future. Of more immediate practical concern, the request for increased taxation to finance a war would require the support of Parliament and public opinion with regard to the rationale for that war. Ricardo wrote in 1820,

When the pressure of the war is felt at once, without mitigation, we shall be less disposed wantonly to engage in an expensive contest, and if engaged in it, we shall be sooner disposed to get out of it unless it was [sic] a contest of some great national interest<sup>10</sup>.

Ricardo regarded the government's tendency to raise finance through the creation of public debt (ultimately to be paid for by society in the future, and ironically, by increased taxation) as an unnecessary evil.

Ricardo believed in the operation of opportunity cost; that increased defence spending, sourced in higher taxes, would cause current consumption - personal and public - to fall. The financing of the war would be felt immediately in the population's decreased purchasing power and lower standard of living. Logically, then, the decision to enter upon the war would be subject to much more intense scrutiny.

However there were, and still are, other problems with Smith's and Ricardo's advice to governments that all wars should be

10. Cited in G.Kennedy, *op.cit.*, p.11



funded from current consumption:<sup>11</sup>

(a) The ultimate decision to go to war, or at least commence military operations of some sort against another nation or enemy, is not based on economic issues of available finance, ready loans etc. (however economic the causes of the war might appear to present politicians or future scholars). The decision to do so, or the debates (public or private) on the wisdom of that decision, is based on political, strategic or even psychological factors which are often almost totally divorced from economic considerations. A nation which is ostensibly close to bankruptcy can afford a war if it is perceived as necessary. Smith had already observed that "there is plenty of ruin in a nation", implying that the level of aggregate sacrifice inherent in a country's ability to absorb the costs of war are almost limitless if the national interest urgently requires it (or if the prevailing power elites believe it is required);

(b) the national debt already existed, had been used to fund previously successful wars and the country appeared to be stronger and more secure for it; and

(c) even were a war debate to focus on the pros and cons of taxation or loans as the means of generating war finance, there remains a fundamental difference in choosing between the two. Firstly, the loan may approximate the national interest better (in that a loan will be paid for in aggregate eventually by the taxes of a future and victorious society) than present taxation which could be viewed more from personal interest. Secondly, a loan is nearer to the concept of defence/security as a public good. It is, in theory, a levy on society as a whole and avoids the divisiveness of taxation - at least in the short term - where those interests opposed to the war are expected to also pay for it regardless of democratic principles.<sup>12</sup>

The simple and clear-cut choice between taxation and the creation of public debt (or further public debt to be more accurate) to finance wars were the two options available to 18th and 19th Century governments. The size of modern central government, particularly as its expenditure constitutes such a large percentage of Gross Domestic Product (in Australia in 1986-7 about 27%), the densely packed and interdependent policy environment in which the government operates and the increased number of financial policy options available to it have created a new and complex web of possible consequences for public

11. Although it should be noted that Ricardo held this belief more strongly than Smith.

12. Sensitivity towards this dilemma of democratic principles, often ignored in practice, was important in deciding to fund the American involvement in Vietnam largely by means of borrowing.

decision-making in times of conventional strategic crisis. Nevertheless the various options and financial policies still fall under these two broad headings: taxation and borrowing.

## 5. The 19th Century

The writings of Smith and Ricardo on war finance and the public debt were not isolated "voices in the wilderness". Thomas Jefferson regarded it as morally wrong that one generation should be required to pay off the war debts of a previous one and believed that any public debt should be discharged within twenty years of its inception. He thought a balanced budget so important that he proposed enshrining the concept in the US Constitution, a move recently revived.<sup>13</sup> In the same period, Jean-Baptiste Say (*A Treatise on Political Economy*, 1803) objected to borrowing by governments unless it were justified to the extent that it produced economic returns of equivalent value - for example, the government might borrow to build a bridge to facilitate transport and market access etc.; the cost of borrowing would thence be redeemed by the bridge's social value, its public utility.

But war is a public utility of another kind. In the nineteenth century, in straight cost-benefit terms war became increasingly unproductive. Smith had already noted that the "soldier... has no revenue to maintain himself, he must necessarily be maintained by the public". Worse, not only was the peace-time military increasingly expensive ("The powder which is spent in a modern review is lost irrecoverably and occasions great expense") but wars were increasingly expensive to pursue ("The cannon and mortar are not only much dearer, but much heavier machines than the balista or catapulta; and require greater expense, not only to prepare them for the field but to carry them to it.") Additionally, the conduct of war - in Europe -

13. Thomas Jefferson to John Taylor, 26 November 1798, in *Works*, ed. Paul Leicester Ford, Vol. VI11 (New York: G.P. Putnam's Sons, Knickerbocker Press, 1904), p. 481., cited in Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World*, New York, Simon and Schuster, 1986, p. 372. "I wish it were possible to obtain a single amendment to our constitution. I would be willing to depend on that alone for the reduction of the administration of our government to the genuine principles of it's [sic] constitution; I mean an additional article, taking from the federal government the power of borrowing."



ruled out the notion of conquest, which in the past had had the benefit of making war a self-supporting economic activity<sup>14</sup>. War pursued as a matter of public policy by reasonably settled national states meant that the costs would be very high and the benefits suspect or intangible, as the resulting victory or defeat provided but marginal differences only to the financial balance sheet borne by the state involved (especially if it were a limited or ideological war, such as the American Civil War). Therefore, in the first half of the nineteenth century the idea was prevalent that, while war might bring victory, it was certain to increase the public debt.

But, with the increasing sophistication of the nation-state and the complementary development of its central bureaucracy and attendant political economic theory, the attitude towards debt gradually changed. By the middle of the century debt came to be viewed increasingly as:

- \* Something a people owes to itself (the government borrowing from the people, in whose interests the war would be fought); and

- \* Relative to a country's ability to pay (increased debt might be outweighed by a proportionally greater increase in the country's productivity, later to be called GNP).

Debt ceased to be an unnecessary evil, or immoral, and adopted many of the features of objective economic argument<sup>15</sup>. Lincoln, for example, thought that the people would not be oppressed by a debt owed to itself. His successors asserted (like modern

14. ie. if successful; see Webber and Wildavsky, op.cit.; the authors come to the sober conclusion that direct internal taxation and forced labour (resources) ensured a greater and more reliable rate of return than war, or conquest, with its attendant costs and risks. Economic gain has seldom been a prime incentive for war. From the outset of the modern era, the obvious gains from war have decreased while the costs have risen dramatically; see pp.238-9 of Webber and Wildavsky: annual expenditure on wars: 1. England, 4,000 pounds in 1600 to 4 million pounds to 9 million pounds in 1700; 2. France, 4.5 million livres in 1607 to 100 million livres in 1706. Nevertheless the classic exception to the rule is the one following the Roman conquest of Macedonia in 167 B.C.; Roman citizenry was exempted from personal taxation for half a millenium afterwards.

15. For example, if borrowing is used to generate national income, then the net addition to wealth (after repayment of the debt), measured often by real growth in GDP, warrants the initial borrowing; or, if the substance of debt is never repaid but the interest payments constitute a decreasing portion of GDP, again borrowing is warranted; or, if debt continues to increase but at a rate lower than real growth of GDP, again borrowing is validated by appeal to positive economics. All these examples represent borrowing as investment into productive enterprises; the problem arises when borrowing is targeted for public works, war purposes and/or rolling over outstanding debt.

supply-siders in the 1980s) that capacity to repay public debt increased with the nation's growing wealth. *Macaulay, at the end of his History of England*<sup>16</sup>, composed an eulogy of the institutions which had made England great and which amounted to a celebration of his belief in the positive role of economics in approaching the problem of debt. The national debt, created with the Bank of England, had fuelled the financial instruments of policy which allowed England repeatedly to crush the mercantilist policies<sup>17</sup> of France:

Why meet the extraordinary charge of a year of war by seizing the [goods] of hard-working families... when Change Alley [the 17th century equivalent of the private banks] was swarming with people who did not know what to do with their money and who were pressing everybody to borrow it?<sup>18</sup>

Macaulay added that future credit to a nation depended on that nation's previous power and inclination to pay past debts:

The power of a society to pay its debts is proportional to the progress which that society has made in industry, in commerce and in all the arts and sciences which flourish under the benignant influence of freedom and of equal law. The inclination of a society to pay debts is proportional to the degree in which that society respects the obligations of plighted faith<sup>19</sup>.

In the last two decades of the nineteenth century the budgetary process and philosophy took on a recognizably modern shape. The age was dominated by the search for (and in budgetary terms, achievement of) social order. The budget acquired a predictive

---

16. Written during the 1850s.

17. Mercantilism was personified by Colbert, the finance minister of Louis XIV. As an instrument of policy in this case mercantilism degenerated into a means of extracting huge revenues for pursuing the ultimately unsuccessful wars of aggrandisement initiated by Louis (ie. no rate of return). The features of mercantilism included defence industrial autarky (recognized by Smith), rigidly centralised financial policy for revenue and expenditure and favourable balances of trade and payments. It became, under Colbert, what Robbins later called "apoplexy at the centre and apathy at the extremities", *The Economic Problem in Peace and War*, p.24. From the naval point of view, Mahan scorned policies which were a mere overlay and did not stem from the natural occupations and habits of the people (*The Influence of Seapower Upon History, 1660-1783*) - eg. sailmaking was linked to the merchant marine in England but had to be artificially fostered in France.

18. Lord Macaulay, *The History of England*, edited and abridged by Hugh Trevor-Roper, Hammondsworth, Penguin English Library, 1979, p.492.

19. Ibid., p.498. Macaulay correctly highlights four vital aspects of national debt stemming from war:

- (1) the highly psychological aspects of raising loans and incurring debt based on past experience of respect for the "rules";
- (2) the generation of national debt is not a problem if its growth is outpaced by increases in overall productivity or wealth;
- (3) debt is incurred to alleviate or add to general expenditure; it is not raised for the specific purpose of conducting war;
- (4) the creation of debt is the readjustment of wealth in the community; the lenders still gain.

capacity. After Ricardo, the next seminal thinker to produce original work on war finance was not until J.M.Keynes. What coloured the latter's thinking was not an entirely original methodology of financing wars but instead an adaptation of economic thinking to the evolving machinery of state finance since its transformation around 1900. These changes, in the broad, included:

- \* The multiplication of governmental functions and the greater centralization of its role in determining the financial well-being of the state as a whole;
- \* The assumption of a central role by the budget process in the life of the government;
- \* The rise of income tax as the key source of revenue for the government;
- \* The achievement of "...annualarity, balance and comprehensiveness"<sup>20</sup> in Western budgets; and
- \* The recognition that borrowing was the key means to pay for war.

The professionalization, centralization and public administration of taxing and spending were symptomatic of the new industrialized age of mass society. It coincided with the second industrial revolution, mechanical invention, ways of organizing work, the growth of the proletariat (including its spending power) and the search for order and efficiency (Progressivism).<sup>21</sup> Welfare funding was also organised as a state function at this time but, except in Bismark's Germany, it remained small and did not yet compete with, let alone surpass, the monies allocated to defence.

## 6. John Maynard Keynes

Unlike the wars of the eighteenth century, the world wars of the twentieth century did not produce seminal economic works, nor

20. Webber and Wildavsky, *op.cit.*, p.428

21. "... by the middle of the nineteenth century, commentators had begun to write of the mighty fiscal engines of government. As they developed into structures we can recognize and understand, financial administrations became powerful instruments for extracting revenue from the public, and then spending it for collective purposes that had no precedent in Western history. The wars of mass mobilization and the welfare state would not have been possible in the twentieth century without a vast increase in the ability to mobilize and allocate resources in the nineteenth century.", *Ibid.*, p.300.



did they set in place extensive institutional mechanisms from which finance could develop further its traditional role as the "sinews of war". The world wars accelerated prior trends in fiscal management and endorsed the arrangements set in place before 1914. But while the wars emphasised financial continuity and not radical change, the level of spending ballooned exponentially.

During World War 1 the UK financed about one third of its war effort via taxation, the rest by borrowing (unlike France which financed only about one sixth of its war effort by taxation). The UK was able to do this because of the income tax system which had been in place for over half a century<sup>22</sup>. Nevertheless, Keynes was critical of the war effort as financed, for two reasons:

(a) During the war, the impact of inflation on wages was used as a de facto policy instrument by the British Treasury to raise the necessary yield of taxes (an early form of fiscal drag) to assist in paying for the war. As a result of an intensive industrial war effort and resulting demand for labour, average purchasing power increased but, because of rationing, was able to buy only the few consumer goods available. Prices rose and profits ended up in the hands of the entrepreneurial class, the suppliers of either war goods or consumer articles. After 1918 the accretion to the national debt was thus "owned" by the capitalist class.<sup>23</sup>

(b) After the war, as aggregate demand (so much based on the government's demand for war-related supplies) fell, a massive post-war slump ensued.

The *Economic Consequences of the Peace* (1924) which criticized these events led to *The General Theory of Employment, Interest and Money* (1936) which in turn dealt with the economic causes and consequences of the Depression. Keynes was concerned with two broad areas of government economic policy:

22. Ibid., pp.438-440.

23. For example, *The Official History of Australia in the First World War* records an increase in the money supply from 9.6m. pounds in 1914 to 57m. pounds in 1920. During this same period the price index moved from a base of 100 in 1913 to 247 in 1920, which represents an inflation rate of some 14% pa. The price index for explosives rose about 24% between 1914 and 1918, or about 5.5% pa. However, in WW 11, the general inflation rate was only some 5-6% pa., due largely to wage and price controls, and general government interference in the economy. This policy stemmed to a large extent from the perceived failures of government activity in the First World War.

- \* maintenance of aggregate demand, particularly to counter slumps; and

- \* the role of government in acting as a stabilizer, not only by its own size but through conscious financial policy with which to interfere in the market as a fine-tuning instrument.

Keynes disparaged "...the abstract notions of Ricardo"<sup>24</sup>. It was unrealistic to expect society to pay for a modern war by taxation alone. Keynes' own theory proposed deliberately unbalanced budgets (ie. budget deficits) in peacetime to revive economies and relieve human misery from the extremes of laissez-faire economics. Wartime would exacerbate the amount but not alter the purpose or nature of these deficits.<sup>25</sup>

Yet there is a certain irony that Keynes, in arguing for budget deficits and borrowing, and attacking economists of the past like Ricardo for their purist stands on economic issues, instituted the first imaginative steps for dealing with the subject of war finance. He addressed the issue of taxation in isolation from the other well-used method of war finance - borrowing.<sup>26</sup>

In November 1939 "...when the necessities of a war economy [must be] realised..."<sup>27</sup>, Keynes wrote a series of articles for The Times on the issue of war taxation (or "financial technique" combined with social justice); these were consolidated into book form in 1940. For the success of his radical proposals, Keynes was modest; they were "...not rejected either by experts or by the public [and] no-one has suggested anything better". He labelled his draft proposals "compulsory savings":

- \* Income tax was to be levied progressively on income and sales; this "war tax" was to be returned to the people after the war, in instalments to avoid both inflation and a postwar slump;

24. John Maynard Keynes, *The General Theory of Employment, Interest and Money*, London, Papermac 12, Macmillan and Co.Ltd., 1964, p.340

25. Ricardo and Smith were both prepared to tolerate public deficits, but only in wartime.

26. Lord Robbins stated that in his pamphlet of 1940, Keynes' "explicit object was to minimize recourse to the totalitarian controls which the financial exigencies of the war bade fair to make necessary.", L.Robbins, *Money, Trade and International Relations*, London, Macmillan, 1971, p.77. The pamphlet's prescriptions also served to control inflation.

27. John Maynard Keynes, *How to Pay for the War*, London, Macmillan and Co. Ltd., 1940, p.iii



\* The price mechanism was to remain central to British society, but at a much reduced level; ie. while the Government would dominate much of supply and demand, a larger proportion of discretionary post-tax income would remain at the disposal of the consumer than would be possible in a society where direct and "total" controls were devised and imposed. This would strike a balance between the needs of a society engaged in total war and the political and economic liberty of the individual consumer.

"Compulsory savings" was distinguished from taxation in that it would be repaid to the workers after the war. They were, in fact, tax credits, the Government borrowing from the people; they were also the people's personal investment in the war effort. Keynes was concerned that otherwise heavy taxation would undermine the individual's patriotism, not to the point of treason but probably to the extent of lethargy, and hence lower national efficiency. Instead, he wanted to harness self-interest to the national interest.

The problem was to devise "a means of adapting the distributive system of a free country to the limitations of war"<sup>28</sup>.

Underlying the plan was both the fear of inflation<sup>29</sup> (as experienced in World War 1) and belief in the equality of sacrifice.

In short, Keynes' plan entailed a withdrawal of excess purchasing power from the consumer at a time when fewer goods would be available). The surplus purchasing power was a consequence of increased worker income from longer working hours required to meet Government demand for the war effort (Keynes noted that in total war "...nothing is more certain than that the wages bill of this country will increase"). His plan would minimize the effects of inflation during the war, would minimize the level of government borrowing otherwise incurred, and would

28. Ibid., p.7

29. It is of note that the Australian government in 1940 decided that the diversion of purchasing power from private to public uses was the only alternative to inflation. This had the additional advantage of reducing the demand for imports. The war reached such an intensity by 1942-43, that with survival at stake, inflation was sacrificed for the sake of defence industrial production. But it was recognised that if the growth in money supply was balanced by an equivalent rise in productivity then the worst effects of inflation would be minimised.

sustain aggregate demand after the war when the Government's stimulus of the economy via war production would cease.

Keynes judged the alternative to be a repeat of World War 1 - shortages followed by rationing. The fewer goods available would lead to domestic inflation and would eventually have a deleterious effect on the balance of trade as individuals imported what was no longer available locally.

Keynes' plan was broadly adopted in the early stages of the war and then later adapted to circumstances as that war became "total". In the end, taxation paid for 52% of the UK's war effort as opposed to about one third in World War 1<sup>30</sup>. Another significant source of funding was the sale of overseas assets.

#### 7. Lord Lionel Robbins

Writing after the war in which he had been an active adviser and economic administrator, Robbins was gently critical of Keynes. He called the latter's plan "...the fiscal theory of war control..."<sup>31</sup> where "a courageous use of the tax instrument was the main desideratum of economic policy". It was, in Robbins' view, suitable for small wars only; it was not "...a theory which ... government has ever had the will to make the effective basis of policy in a war of any great dimensions"<sup>32</sup>. Robbins based his criticisms on the experience of the Second World War, where price fixing, rationing and control of supply proved to be key instruments of government domestic economic policy.

Total war, "...the wars of our own age, with their vast demands on men and materials, their acute scarcities and their utter domination of ... business confidence [ie investment]..."<sup>33</sup>, was the basis for a realistic economic and financial policy. Total war created:

30. Webber and Wildavsky, *op.cit.*, p.478

31. Lord Robbins, *The Economic Problem in Peace and War*, London, Macmillan and Co. Ltd., 1950, p.32

32. *Ibid.*, p.32

33. *Ibid.*, p.33

- \* Necessities of supply almost independent from market forces;
- \* Abnormal conditions of risk;
- \* The unreliability of market price as an allocative mechanism where government credit is unlimited;
- \* Time lags in filling supplies, thereby assuming some shortages and resulting inflation; and
- \* Unity of purpose - ie. competing funds have priorities set by overriding goals of national security.

Time also had a role in Robbins argument; in war at any level there must be a time lag before tax collection becomes usable revenue. The interim period "...must be filled by increased borrowing..."<sup>34</sup>.

Robbins' proper financial policy for large scale war involved:

- \* Taxation - reduce consumer demand/purchasing power (to control inflation);
- \* Subsidies - the profit incentive to supply government demands; and
- \* Borrowing - preferably on a non-inflationary basis (ie. within the context of a stabilized money supply).

Robbins' argument was based on the notion that security was a public good; it was approached, and achieved, through political determinants. Not even in peace time was it subject to true market forces. War required the government's assumption of command over resources, not competition for them and "...necessarily put the individual at a discount..."<sup>35</sup>.

Robbins' work was an endorsement of the experience of the Second World War where the resources of the state devoted to war reached truly gargantuan proportions. This experience is unlikely to recur since the amount of social energy (or mobilisation) required to achieve the same level of destruction, via various levels of nuclear exchange, is now much reduced.

34. Ibid., p.35

35. Ibid., p.15



Therefore, the economic base, as opposed to the financial policies, required to support a national war effort are also much reduced. The conduct of limited war by the modern state is more akin, in economic terms, to a "credit squeeze" with attendant marginal adjustments to financial policies. The state descends by degrees to its previous role of player (nevertheless a vital player) in the economy, down from its total role of economic overlord in the first half of the 20th Century.

Since Robbins wrote, very little if anything has been added to the literature on war finance, largely because there have been few wars significant enough in the last half of the century to impact substantially on the resources of the state, to require a new role for the practice of war finance, or to call on the imagination of its professional and academic servants.

## 8. Conclusion

Three budgetary trends have been identified in western states in the post-war period:

- \* Increased spending on social programs (particularly health, education and welfare); increased differentiation of functions within the state has produced internal competition for funds, as opposed to the previous period where the few functions of the state (defence, justice) commanded the attention of government;
- \* Decreased military expenditure relative to both Gross National Product (GNP) and central government budgets despite real cost growth in personnel and weapons systems; and
- \* The inability of increasing government revenue (through taxation) to keep pace with the increasing proportion of expenditure accounted for by the public sector, leading to sizeable peacetime budget deficits.

In the event of any future defence contingency it will not be a simple matter of selecting either one experience and/or one theory of war finance for the underpinning of that contingency. It will be a matter of financial policy based on the existing actors and institutions at the time relying on the accumulated

wisdom of the above authors.<sup>36</sup> Policy advice and decision-making will be based on possibly differing perceptions of the same events as well as on prior theoretical insights. These might include:

- \* The degree of personal, social, political and economic liberty to be retained or sacrificed;
- \* The size, trends, duration and likely cost - political, social and economic - of the contingency; and
- \* How much the government can afford to spend, borrow, and/or forgo for the conduct of the contingency.

Keynes wrote in 1939:

It is not easy for a free community to organize for war; ...our strength lies in our ability to improvise<sup>37</sup>.

The following generalisations can be made about the financing of the USA's wars for the last two hundred years:

\* Wars were directly and almost solely responsible for accelerated increases in the national debt up until 1931. After the latter date debt continued to grow regardless of the state of war or peace, not least due to the adoption of a Keynesian approach to economic management. This included features such as the quest for full employment (which Keynes thought was reached when unemployment was 3-4 per cent), deficit financing, public works programs, etc. The central economic role of the state was to act as mediator in the maintenance of aggregate demand. This role had previously been undertaken in wartime only.

\* Apart from cyclical business depressions, balance-of-payments deficits coincided almost exactly with the years in which America was involved in war.

36. "...to observe by experience, and remember all circumstances that may alter the success, is impossible....But in any business, whereof a man has not infallible science to proceed by, to forsake his own natural judgement, and be guided by general sentences read in authors, and subject to many exceptions, is a sign of folly, and generally scorned...", T. Hobbes, *The Leviathan*, Chapter V, Vol.23, *The Great Books of the Western World*, Encyclopaedia Britannica Inc., 1952, p.60.

37. Keynes, *op.cit.*, p.1

## CHAPTER 2: FINANCIAL MANAGEMENT OF LIMITED CONFLICT

The following four case studies provide concrete examples and historical substance to the discussion of theory in the preceding chapter. They attempt to locate the ideas of the aforementioned economists on raising war finance within the context of contemporary conflicts, and to build on their insights.

### 1. The USA's Experience and Vietnam

Throughout its history the United States has opted to finance its wars largely via loans, and has been generally reluctant to tax, or increase existing taxation, for the sake of the nation's security. Indeed, its first national war, the American War of Independence, was fought against the onus of foreign taxation<sup>1</sup>. Because loans could not be raised, and there was then no internal capital base which could be tapped, the war was paid for by the printing of money, which resulted inevitably in inflation running out of control.

The following generalisations can be made about the financing of the USA's wars for the last two hundred years:

- \* Wars were directly and almost solely responsible for accelerated increases in the national debt up until 1931. After the latter date debt continued to grow regardless of the state of war or peace, not least due to the adoption of a Keynesian approach to economic management. This included features such as the quest for full employment (which Keynes thought was reached when unemployment was 3-4 per cent), deficit financing, public works programs, etc. The central economic role of the state was to act as mediator in the maintenance of aggregate demand. This role had previously been undertaken in wartime only.<sup>2</sup>

- \* Apart from cyclical business depressions, balance-of-payments deficits co-incided almost exactly with the years in which America was involved in war.

1. ie. indirect taxes such as the excise; income tax did not yet exist. It was introduced in 1797 in the United Kingdom to pay for the wars against Revolutionary France.

2. Mercantilists were concerned with surpluses (trade particularly), Adam Smith was concerned with equilibria in the balance of payments and trade, whereas Keynes specified that these concerns were immaterial in the short term.



\* Taxation, as a component of financing America's wars, has slowly assumed a more important role but one which Americans have generally been reluctant to invoke.<sup>3</sup> In broad economic terms, wars have been more unpopular in the American experience than in similar contemporary periods of European history.

In the first decade of the 19th Century Albert Gallatin, Secretary of the Treasury, espoused a philosophy of war finance which echoed the principles of Adam Smith and the policies of Thomas Jefferson. Gallatin detested the notion of raising loans to fight wars when the present population was the generation which stood to gain most out of that war. He argued that the present generation should, as far as possible, be the one to pay for the war - by taxation. But even in Gallatin's era, public expenditure might be doubled under the impact of war whereas revenue could not do likewise, even in the long-term. Therefore, war was to be paid for by loans, the issue of bonds etc. The return of peace would afford the resources (for example, excise from increased trade volume) for paying back the war loans, which were specifically differentiated from other government loans. The central government should pursue a policy of parsimony in peace to plan for the costs of future wars. The policy of running a deficit in peace time (ie. along Keynesian lines to maintain full employment) was inimical to both Gallatin and the age.

Until the 1930s, the US did experience a war-peace dichotomy in the handling of its public finances. Peace was generally "parsimonious" and provided surpluses in the balance of payments which were useful in repaying the debts incurred in fighting wars, particularly the enormous costs of the American Civil War.<sup>4</sup>

3. Taxation was introduced as a form of war finance, (ie. directed specifically for this end), for the War of 1812 where 95% of war expenditure was still covered by the raising of loans, normally done by the sale of government bonds. The Mexican War (1846-48) and Spanish War (1898) were paid almost entirely by loans; the Civil War (1861-65) was financed by the North - 22% taxation, and the South - only 5% taxation (in victory the North would not honour the South's borrowings, domestic or foreign, illustrating the desire of creditors for victory). In WW1, taxation increased to 31% of war finance; in WW2, this figure jumped to 40% despite the increased productivity associated with America's participation in this last war; see Paul Studenski and Herman E. Kroos, *Financial History of the United States*, (New York, McGraw-Hill Book Company Inc., 1952).

4. The costs of conducting a civil war are particularly severe since both the protagonists must draw from



After World War Two, US social spending (health, education and welfare) increased dramatically and, except for several budgets in the 1940s and 1950s, Federal deficits became the norm. During the 1950s,

Instead of attempting to allocate defense and social needs within a limited budget, the adherents of this view ["guns" and "butter"] advocated ever-increasing spending for both defense and social goods - but without raising tax revenues to cover these expenditures.<sup>5</sup>

The Vietnam War co-incided with the Great Society program of social spending and severely exacerbated the trend towards increased government spending and debt.<sup>6</sup>

Like other wars, particularly the Korean War, the Vietnam involvement was initially controversial and, at length, largely unpopular.

The lack of public support for the activities in which the military establishment was engaged after 1964 might at first be assumed to have severely constrained the defense budget. But successive administrations proceeded without public support by paying the defense bill with bonds and new money [ie. increasing the base money supply without a commensurate productivity increase: the key ingredient for inflation]... The military was funded without immediate public sacrifice in a "credit card" philosophy - because the public did not pay promptly for the military goods that were purchased, initially it seemed as if no one had to pay at all.<sup>7</sup>

Any Western democracy normally has two opposing philosophical and practical methods to manage a war-induced dilemma (with features of both to ameliorate the extremity of these two opposing options):

(1) To remain a free society engaged in a limited war; or

(2) To institute direct controls over resources for the purposes of total war.

The financial difference between these two options, as much the results of happenstance as of philosophical belief, is that in the first, the price mechanism of the market remains central to the continued means of distribution in society. In the second,

essentially the same tax base. Hence, the heavy reliance on loans to conduct a civil conflict.

5. William J. Weida and Frank L. Gertcher, *The Political Economy of National Defense*, (London, Westview Press, 1987), pp.18-19.

6. See Wildavsky, op.cit., "The last three years of the Johnson administration - with the War on Poverty [and] the War in Vietnam...produced a jump of about 5 percent in government share of GDP. Of this, 2 percent seems to have been war-related, one percent general federal social programs, and 0.5 percent targeted federal social programs; the rest occurred at state and local levels, largely as a result of federal initiatives."

7. Ibid., p.18.

this system is suspended and replaced by such centrally controlled features as rationing and price fixing. This latter can have some of the elements of mobilisation, where the central authority assumes control of the workings of supply and demand to channel production into selective and useful areas for national security.

In the 1960s successive US administrations opted for the former approach - to conduct a limited, unpopular and defensive war in Vietnam while retaining the institutions and traditions of a democratic society. Contrary to the strictures advocated by Keynes, the US government, particularly the Johnson administration, elected to pay for the war by borrowing heavily from the Federal Reserve and not by increasing taxation.<sup>8</sup> Being then the world's dominant supplier of goods and services and with some 80% or more of the world's financial transactions denoted in US dollars, this policy fuelled a significant global inflation which led the US to withdraw from the gold standard in 1971 (the "Nixon shocks") and dislocated the global economy for the decade following. In 1972 William Proxmire wrote:

...we discovered that we could not have guns and butter without serious inflation. Sharply increased spending on both the Vietnam War and rapidly expanding social programs at home combined to plunge us into a crisis that still plagues the nation.<sup>9</sup>

## 2. Australia in Vietnam

Australia's Vietnam involvement (June 1965 - December 1971) did not require any significant changes to the government's existing obligations of financial accounting or reporting. No special needs were created by the incremental costs of the war. Indeed, the management changes affected in the early 1970s had far greater impact on the "business" of defence than did the Vietnam conflict.

8. Income tax, as a percentage of government revenue, actually fell from 44% in 1960 to 43% in 1973; cited in Proxmire, *Uncle Sam: The Last of the Bigtime Spenders*, (New York, Simon and Schuster, 1972), p.173.

9. William Proxmire, *op.cit.*, p.22.

Defence expenditure had reached a peak in Australia's history in 1942-3 when some 40% of Gross National Product<sup>10</sup> (GNP) was allocated to defence needs. After 1946-7, except for two distinct periods involving commitment to limited wars outside Australia, defence spending in Australia has hovered between 2.5% and 3.5% of GDP<sup>11</sup>. This range is as much a reflection of personnel numbers and expenditure patterns (often determined by procurement schedules) as it is a commitment to any particular defence philosophy.<sup>12</sup>

The two periods of higher defence expenditure were associated with the Korean and Vietnam military involvements. In the first, defence expenditure peaked at 5.1% of GNP in 1952-53; in the second, defence function outlay (broadly, defence expenditure less revenue from rent and sales etc.) reached 4.4% of GDP in 1967-8. This briefest of empirical evidence would suggest that a relatively low level of military commitment involving some thousands of troops (8,000 in Vietnam on active service at the peak) may account for up to 5% of GDP. In 1952-3 this commitment represented 15.8% of government expenditure and in 1967-8 17.1% of budget sector outlay.

It is nearly impossible to determine the exact means by which successive Australian governments financed the war. No specific taxes can be attributed to the Vietnam War. While taxation increased substantially over the three decades from the mid 1950s, this was due to other causes - such as inflation drawing wage earners into higher tax brackets - rather than any purposeful design on the part of the Federal Government to finance military operations.<sup>13</sup>

10. Gross National Product (GNP) is different from Gross Domestic Product (GDP) because it includes income earned outside Australia and is accounted for on its repatriation. The numerical differences can be significant or quite small, depending on the particular country's means of income.

11. In 1988-89 it was estimated to fall to 2.4% of GDP.

12. Defence expenditure was 2.8% of GDP in both 1959-60 and 1981-82, even though strategic policy had altered radically.

13. One commentator on this paper, Mr. M. Ives, a senior officer in the Department of Defence who has had long involvement in dealing with defence finances, suggested that the avoidance of any decision by successive governments in stopping or reducing this increasingly large appropriation by taxation was in itself the basis for funding the Vietnam involvement.



The Federal Government ran successive small deficits during the period of the Vietnam involvement but again this form of government economic activity was largely independent of the specific needs of war finance. The difficulty in attributing revenue to spending in the Australian experience stems from several factors:

- \* The different organs of government which are responsible for revenue (Australian Taxation Office, Custom Services etc) and expenditure (only one of which is Defence) function independently of the other with little reference to either where the funds are coming from (if a "spending" department) or how they will be spent (if an agent of revenue collection).
- \* The bids for expenditure are more often measured against competing expenditure functions than against availability of immediate resources (the temporary lack of which can be covered by borrowing).
- \* Expenditure comes from consolidated revenue, not specifically identified.
- \* "How much is enough?" is not the same as "how much is available?" and these rhetorical questions are often linked only in the most tenuous fashion.

Successive annual *Defence Reports*, issued since 1963, avoided the identification of the financial costs of the Vietnam War to Australia. Only the 1967 Report commented that "...additional costs arise from the decision to enlarge our Vietnam commitment...".<sup>14</sup> Unlike their American counterparts, the input accounting figures dutifully recorded in Australian *Defence Reports* during this period made no mention of Vietnam operations in the lists of line items. Indeed, the peacetime accounting concern with equipment acquisition, personnel numbers, and planned and achieved expenditure, predominated. The broader political and economic picture was beyond the horizon, and, quite correctly, beyond the defined responsibilities also of Defence, as set out in various *Defence Reports* during Vietnam (and after). It becomes quite clear that Defence's role then and now is to form a unit of government expenditure consuming a certain percentage of government allocations in order to carry out political and economic policies worked out elsewhere.<sup>15</sup>

14. *Defence Report 1967*, (Australian Government Printing Office), p.13

15. Annual *Defence Reports* have become more sophisticated and painfully enlarged since the Vietnam war. For

### 3. Argentina and the Malvinas Conflict, 1982.

The initiation of the Falklands/Malvinas War by Argentina in 1982 was viewed by the international financial community, particularly the IMF and Argentina's other creditors, as an extreme case of a government willing to risk military adventurism of the most unproductive kind and hoping to distract the population from the internal consequences of debt (a declining standard of living). The war stemmed from historical and ideological roots. In economic terms, the revenue from the islands hardly warranted the expenditure of some half a billion US dollars by the Argentines and some half a billion pounds by the British.<sup>16</sup>

The Falklands War illustrates two basic precepts governing the political willingness of modern indebted states initiating or responding to military confrontation:

(1) The prevalence of alarming economic indicators<sup>17</sup> will not necessarily stay the decision of a country to go to war, or at least initiate limited military action or response<sup>18</sup>; economic caution - which will measure the war in cost/benefit terms - cannot be said to prevail over "national honour", strategic factors, public pressure or political intentions; and

(2) Given the availability of "war on credit", and the capability of a government to fund a war (by issuing short-term bonds, short-term borrowing, etc.), severe and/or immediate economic problems might not influence the

example, in economic terms: 1971 - first mention of Defence as a percentage of GDP; 1974 - introduction of functional analysis of defence outlays; 1975 - introduction of graphs, bar charts, trends etc. While Program Budgeting is designed to clarify the spending outputs of various force elements of Defence activity (eg. just what is the cost, annually, of a squadron of F/A-18s) there is as yet no institutional vehicle designed to measure or illustrate the costs of wars, although crude measures have been made of the costs of the larger exercises like the Kangaroo series.

16. The war also lacked an obvious strategic rationale, particularly from the British viewpoint. Nevertheless, the waging of the war illustrates a point: that psychological, national and/or broader strategic factors (eg. the immeasurable but very real non-financial cost of doing nothing) may outway economic factors.

17. *The Economist*, 1 May 1982, p.28: "For the harried business community of Buenos Aires, the threat of war has posed just one more hurdle in the daily struggle to survive inflation and sky-high interest rates." These included: inflation of 150%, real interest rates for loans at 20-30%, annual interest rate on 7-14 day deposits at 90% (indicating the desperation of the government to secure deposits).

18. In an article on 9 April 1988, the *Canberra Times* reported that in May 1982, Argentina was desperately seeking more French Exocet missiles (30 all told) and that "Money was no object in the search for weapons that could reverse Argentina's sagging fortunes."

development of the politico-military crisis to any great degree.

In 1982, Argentina was experiencing inflation of 208% and had accumulated a foreign debt of \$US35.7 billion, which reached \$US 43.6 billion in 1983. Growth of GDP had plummeted to -6.3% over the preceding year while external debt as a proportion of GDP had reached 39.7% (while debt servicing of that amount had reached 7.4% of GDP). Despite these statistics, Argentina engaged in a war with the UK.

The Falklands War had a serious economic impact on Argentina, hastening and exacerbating the slide in economic conditions which had been in train for the previous three decades:

(a) **Internal:** the government attempted to pay for the war and mitigate the plunge into recession by cutting public capital spending, imposing taxes on petrol (to raise \$US55 million in a full year), increasing imposts on cigarettes and alcohol by 30-75%, imposing a 6 month wage freeze and devaluing the peso by 14.3% against the \$US. However, the reduction and later withdrawal of government guarantees on savings accounts led to an immediate run on deposits in Argentinian banks, which in turn led to interest rates rising dramatically and fuelling inflation as the extra liquidity sought security in assets and goods.

(b) **External:** in May, the European Community - recipient of 25% of Argentina's exports, mainly farm products - imposed trade sanctions against Argentina (worth \$US1.3b p.a.). This was followed by similar sanctions from British Commonwealth countries (worth \$US80m p.a.). Argentinian assets in London (about \$US1b) were frozen and arms sales to Argentina were restricted. Ironically, Argentina's overseas debt became a tool in its favour. It halted the debt repayments owed to its UK creditors, who in turn became anxious advocates of peace, or at least a return to the negotiating table.

(c) **Monetary:** the peso stood at 10,000 to the \$US1 in March 1982; the April devaluation reduced this to 14,000 in April; in July, the official rate stood at 20,000 to the \$US1.<sup>19</sup>

With industrial output plummeting, workers laid off and foreign reserves at \$US2b, an IMF delegation arrived in July to decide how the country was to meet its interest payments on its foreign

19. *The Economist*, 15 May 1982.



debt which in 1982 amounted to some \$US4.5b, over twice its foreign reserves.

In June 1982, *The Economist* commented dryly that, "With its existing \$US34b of outstanding external debts, and uncertain policies, it will find the rates far higher than before its invasion of the Falklands - if it can find the money at all". The foreign debt amounted to \$US36b in July. The free market forces of the past 5 years were constricted and the exchange rate float of December 1981 was effectively re-regulated in June 1982.

While it is difficult to estimate the total financial costs of the war on Argentina, its impact can be measured in three ways:

(1) The growth of its foreign debt by some \$US2b in two months. The war caused an acute debt crisis in Argentina in 1982 and private bankers reduced loans because of it. Creditors, particularly the IMF<sup>20</sup>, do not lend for the purposes of war. Argentina raised loans on the Eurocredit market, a private international capital market largely independent of government and central bank controls, but one which charged higher interest rates.

(2) The necessity to reschedule its official and other loans (\$US6b) coming due in January 1983, only the second time it had had to do so in 16 years.

(3) The decline of its credit rating for risk investment of capital from 30.3 to 25.0 (out of a possible 100.0; the USA, for instance, then topped the list with 96.0).

After the war, Argentina proceeded to quickly replenish its arms arsenals despite the diminution of its foreign exchange reserves and earnings, and visits from the IMF.<sup>21</sup> In January 1983 it

20. The International Monetary Fund was set up (1944) to stabilize currencies and financial policies under a fixed exchange rate regime. It was also given the power to provide short- to medium-term loans to governments faced with temporary balance of payments problems. As the former powers have dissipated since 1971 (US suspension of the gold standard), so have the problems grown with the increasing indebtedness of many Third World nations. Now, the IMF is the lender of last resort to governments only and in this latter role it is easily confused with the functions of the World Bank. The World Bank is an international development bank and functions on much the same principles as a domestic, lending bank. (J.K. Galbraith commented wryly that the IMF is a bank, and the World Bank is a fund).

21. It is difficult to determine which capital equipment items were purchased because of the war. The most notable item, 14 Super Etendard aircraft for the Argentine naval air force, were already in the pipeline before the commencement of the war. The differences between the Military Balances of 1981-82 and 1982-83 indicate the extent of the rearmament and also the Argentine air force losses: the Argentine air force had shrunk by some 120 aircraft; Argentine naval aviation had increased by 9 aircraft (the Military Balance also

signed a stand-by arrangement (SBA) with the IMF for \$US1.5b., the SBA being a strictly conditioned form of credit for countries in debt crisis. Another agreement was signed in September 1984 for a similar amount.

By 1988, Argentina's foreign debt had reached \$US55b<sup>22</sup> (79% of GDP), largely due to exchange rate devaluation of its currency and the expression of most of its debt in \$US. Little of this explosion of debt could be attributed directly to the war, with an arguable amount directed to military spending. It has been estimated that some \$US20b of its accumulated foreign debt of \$US48b in 1984 had gone on military spending (half of this between 1978 and 1982 according to the *Military Balance 1981-82*).

Three key precepts of international finance suggest the following<sup>23</sup>:

- \* Foreign loans should be invested productively to earn foreign exchange for the country to meet its debt-servicing requirements.
- \* Debt servicing should not exceed the amount of foreign exchange earned from growth in production.
- \* Increases in tax revenue should remain an option for government to meet debt servicing requirements.

The fear of increased taxes in Argentina led to a capital flight of some \$US12b in 1979-84 from private means. This was invested in real estate and bank deposits overseas etc. and ultimately found its way back to Argentina in the form of international loans.

Argentina was able to continue to gain loans from overseas sources, despite its willingness to pursue small wars, internally and externally. This was so because the list of

---

adds the caveat that all such figures are indicative only).

22. Time, 9/1/1989

23. The IMF tends to use 3 broad principles in awarding loans to indebted countries:

- (1) It uses a case-by-case approach
- (2) Its solutions are market-oriented
- (3) It does not invest in risky ventures over and above what a normal bank would expect to do.

indicators of risk assessment used by major international banks gave low priority to the impact of external conflict on the well-being of the society which requested the loan.<sup>24</sup>

The example of Argentina provides a number of lessons for Australia<sup>25</sup>:

- \* An indebted society will remain able to raise overseas loans for "general purposes" even if that purpose might be guessed to include the conduct of war.
- \* The granting of loans by private banks will be based on purely economic criteria (including the capability of servicing that loan) almost independent of that country's politico-military situation.
- \* The granting of loans by public banks will not be independent of international factors.

#### 4. The MX Missile Crisis, 1985.

In 1982, the Australian Government had agreed to provide limited assistance to the US in its monitoring of two MX ICBM tests; the impact zone of the missiles was originally to be off Tasmania's east coast. The new Government reviewed the plan in May and again in November 1983. Once the impact zone was shifted farther

24. The following list is used by the major private lending banks in the USA and Europe for measuring a country's credit-worthiness (1 has the highest priority, 2 the next highest, and so on):

1. Debt-service ratio
2. Growth of GDP
3. Export structure
4. Per capita income
5. Export growth
6. IMF loans and foreign exchange reserves
7. Foreign debt
8. Monetary and budgetary policies
9. Import structure
10. Labour potential, numbers and level of training/education
11. Ratio of imports to foreign exchange reserves
12. Structure of foreign debt
13. Capacity for peaceful change
14. Probability of internal conflict
15. Minority problems

The likelihood of external conflict is considered so low in priority in the financial assessments of countries that it is listed elsewhere under other "social, economic and political factors".

25. T. Duncan and J. Fogarty, *Australia and Argentina: on parallel paths*, Melbourne, Melbourne University Press, 1984. The dependence of both these countries on immigration and capital inflow and their concurrent slide into deep external debt illustrate a similar future; and this is before Australia's explosion of foreign debt in 1985-86. The defence implication for Australia is that its potential experience of funding a limited conflict will likely be as much akin to the Argentine as that of the UK experience in the Falklands.



out into the Tasman Sea, it was endorsed by the Prime Minister on 16 November 1983, just after a major statement to Parliament in September reaffirmed the value of the ANZUS alliance to Australia. Original tests set down for 1983-84 were delayed until 1985.

On 1 February 1985, the Australian Minister for Defence's office released a statement entitled "Assistance for Possible US Missile Tests". Even though it acknowledged that "the Labor Government is firmly opposed... to the testing of nuclear devices or nuclear delivery systems on or over Australian territory...", the Labor Government had deemed "...assistance arrangements... were acceptable..." to "...provide limited assistance to the US in its monitoring of two MX intercontinental ballistic missile tests...".

Australian assistance was largely confined to allowing US aircraft to refuel in, and fly into and out of, Australia to monitor the tests.<sup>26</sup> The Australian Government expressed its opposition to the South Pacific being used for regular ballistic missile testing and insisted that the original splash site be moved away from offshore Tasmania to international waters. Despite this caution and understatement, and despite the subtleties<sup>27</sup> by which the Government undertook to co-operate with the US while not subverting the spirit of the ANZUS treaty or its own international disarmament policies, the "MX missile crisis" eventuated. It provides an instructive lesson in economic crisis management and the problems that can arise in relation to a "security" issue without the slightest involvement of the military at any stage.<sup>28</sup>

Grounds for the crisis lay principally in the deeply-held opposition to the American alliance by traditional members of

26. The Government was at pains to point out how limited this assistance was: no port facilities for ships monitoring the tests and no communications for the conduct of the tests. The missiles would be unarmed, would keep to a preplanned flight path and would not cross inhabited territory.

27. Obviously, this subtlety was lost on foreign speculators and investors in the ensuing storm. The government might have been true to its philosophy and the words used to defend it might have been more than mere casuistry, but the financial community responds to more than clever nuance.

28. Ministerial Release No.17/85, 4 February 1985.

the Labor Party, the appearance of deception practised by the Government<sup>29</sup>, the apparent incompatibility of the actions with Australia's disarmament policies and the fact that the MX missile was a feasible first-strike nuclear weapon system. The political opposition capitalised on these apparent inconsistencies.

The crisis was not solely about MX missile testing. It was about "...the country's reliability as an ANZUS partner..."<sup>30</sup> "...[T]he whole future of ANZUS and Australian-American defence relationships [had] become a dominating feature of the political scene..."<sup>31</sup>

On 4 February 1985, after a weekend of extensive newspaper coverage, the Minister for Defence attacked his critics for "...speculation unsupported by facts..."<sup>32</sup>; but, in an expression of lack of confidence in Australia's economic and political management, the foreign investment community had already begun to respond to the news of this internal affair by dumping Australian dollars.

In its Annual Report for that year<sup>33</sup>, the Reserve Bank of Australia noted that:

In February, and again in April, the Australian dollar fell abruptly. Nervousness evident first in the foreign exchange market spread to domestic financial markets.... In the aggregate, the Bank was a large net seller of foreign exchange in these months.

In February 1985 the \$A fell 15.5% against the \$US and 13.5% against the Trade-weighted Index (TWI)<sup>34</sup>. Parliament did not sit again until 21 February 1985 and the MX missile debate was the first topic on the agenda. However, it was not until 26 February that John Howard, then Leader of the Opposition, attempted to

29. On 30 November 1984, G. Scholes, then Minister for Defence, had categorically denied that the Australian Government was involved in assisting the testing of US nuclear missiles over its territory. Of course, the US request was for assistance outside Australian territory.

30. *The Australian*, 6 February, 1985.

31. *The Sun Herald*, 3 February, 1985.

32. Ministerial Release No. 18/85, 4 February, 1985

33. Reserve Bank of Australia, Annual Report 1984-85, Parliamentary Paper No. 272/1985

34. The \$A was worth some 0.85c against the \$US in December 1984, about 0.68c in March 1985 and about 0.65c in May 1985; the TWI (100 in May 1970) was about 85 in December 1984, 70 in March 1985, and around 64 in May 1985.

relate the affair to the rapidly depreciating dollar.<sup>35</sup> By attempting to assign the blame the Opposition probably added to the confusion and the depreciation. The Opposition's attack was politically motivated; the Government's response sought to assign economic causes to the fall of the dollar. When Parliament met again in March the consequences of the MX missile affair, for the economy and for ANZUS, had dissipated. When the \$A collapsed again in April (some 11% against the trade-weighted index, making a total of 25% since late 1984) the causes were attributed by both political parties to economic factors - prospective wage and salary increases to be granted to workers in a weakening economy.<sup>36</sup>

The Reserve Bank of Australia <sup>37</sup> attributed the fall in the \$A to:

- \* The rising strength of the \$US, with funds therefore attracted away from Australia for blunt financial reasons (ie. greater gain elsewhere);
- \* "...a range of economic and political factors..."<sup>38</sup> which included:
  - (a) a growing deficit in the balance of payments;
  - (b) suspension of the monetary projection (M3 - the volume of money in circulation, ie. cash, or readily convertible assets) in late January because it "...did not provide a reliable guide to underlying monetary conditions"<sup>39</sup>; and
  - (c) public service work bans which, by not allowing the encashment of government receipts, disrupted domestic financial markets.

Defence was guarded about the cost of the MX missile debacle to it in 1984-5; it required an additional \$200 million to supplement its budget so as to retain its purchasing power in the United States where the overwhelming portion of its overseas

35. see quote by Howard, Hansard, Commonwealth Parliamentary Debates, Vol.140 (?), p.(?); the Prime Minister admitted - *The Daily Telegraph*, 18 February 1985, "...that the defence row surrounding ANZUS and the MX missile tests may have contributed to the fall in the dollar."

36. It is worth noting in this context that the "banana republic" outburst did not come until May 1986.

37. Reserve Bank of Australia, Annual Report 1984-85, p.3

38. Ibid., p.4

39. Budget Statement No. 1 1985-86, Department of the Treasury, p.50.



spending and procurement takes place. Purchasing power had fallen because of detrimental exchange rate movements during the year.<sup>40</sup> However, the cost to Defence pales beside the cost to Australia's foreign indebtedness. An overseas debt of some \$A45 billion in 1984 became \$A65b in 1985 because the currency devaluation had added so much to the level of Australia's foreign debt, denoted largely in \$US. The cost of supplementation represented perhaps 3-4% of Defence spending for that year, but the cost of depreciation on indebtedness cost Australia some 300% of its then annual defence budget.

The MX missile affair was less the cause of than the catalyst for an economic crisis. It was heavily political in tone and of short duration, but it had severe economic consequences. It illustrated several themes:

- \* Economic management has a very high political profile, and in this key element of national security, Defence in its current configuration has almost no role.

- \* Public information is vital, and bad news (or lack of it) will be the determinant of market response.

- \* Since December 1983 (introduction of the floating exchange rate regime), Australia has been subject to intense currency speculation which in late 1984-5 reached \$A9 billion per day.<sup>41</sup> This level of trading is very high for Australia's real market worth. Because it is so dependent on a favourable capital inflow, a future military crisis will require a financial policy in response every bit as effective as a military response, to ensure the country's ongoing security.

40. These recurred in 1985-6, but in 1986-7 Defence was able to report publicly that exchange rate movements had favoured it by \$110m. To retain stable purchasing power year on year, Defence receives supplementation in the event of adverse exchange rate movements but returns any unspent funds to Consolidated Revenue if those same movements are favourable.

41. Budget Statement, cited in footnote no.25.

## CHAPTER 3 : COSTS OF WAR

### 1. Introduction

In traditional economic terms, where military conquest might be compared to investment, war is mere consumption. It may be measured as a financial cost.<sup>1</sup> These costs of war are determined by its input (in labour, materiel and capital) and by the measures undertaken for its support over and above normal peacetime requirements. Victory or defeat might result (political negotiations or military exhaustion could induce compromise) but financially, there might not be much difference between them. Also, in the modern age, with the example of reparations from Germany after WWI and Keynes' warnings on the same, war no longer allows the opportunity for a net aggregate profit for the victorious protagonist<sup>2</sup>.

In more technical financial terms, war might be only a useful multiplication of peacetime defence costs, as measured by accountants, within the allowable limits of the policy makers' balance sheet. This would be so, particularly if it were a limited war fought outside home territory. Additional costs would be incurred otherwise (eg. facilities, civilian losses) which require more sophisticated standards of measurement.

### 2. Peacetime Defence

In peacetime, defence preparation can be readily and accurately measured by its social costs, ie. the opportunity cost of a dollar spent on defence as opposed to its expenditure on welfare, public works, or not being spent at all.<sup>3</sup> The wartime

1. Defence is the peacetime format of war and aims in part to provide a deterrent against its future outbreak. The absence of involvement in conflict - a much more expensive activity - is then used to justify retrospectively the expenditure which is consumed on defence. This cost/benefit approach is problematic since it requires the balancing of defence's immediate and measurable costs against the intangible financial benefits of war not happening.

2. At least to the combatants; examples abound of nations making a profit of the wars/conflicts of others, eg. Australia did very well out of the Korean War. Turkey was congratulated by the IMF in 1983 on the redemption of a considerable part of its foreign debt - after it had done business with both sides during the Iran/Iraq War.

3. The real cost of defence activity is the alternative use of forgone resources (in economics - land, labour & capital; in defence - money, personnel & equipment).

value of defence, however, is not so readily estimated. War entails not only added direct financial costs but provides a test of its value to the nation; it goes beyond normal opportunity and direct cost measurements. In its peacetime role, as defence, war is best measured by its factor costs; the factors of production used as inputs - personnel/labour, facilities/land, and equipment/capital; these combined, form direct costs in dollar terms to produce an output - national security. Accompanying financial cost of these operations plus the US State Department, the Agency for International Development (AID), the Central Intelligence Agency (CIA), National security, as a broad function of state, is treated in this thesis as a "given" and defence's costs are treated in direct dollar terms rather than expressed in the more contentious terms of opportunity cost. Defence is measured in Australia by the standardised NATO definition for defence expenditures.<sup>4</sup> This does not measure some of the more interesting dimensions of defence economics, such as the impact of defence spending on the economy, but it serves as a useful and viable management tool for measuring the direct, dollar costs of the peacetime defence function, and hence of limited wars. It would appear likely that in the event of a low level contingency involving some sort of military commitment, the NATO standard would remain the measure of input costs.

### 3. Limited War - the USA in Vietnam.

In 1966, the Systems Analysis area of the USDOD developed a model that allowed the Defence Department to "program budget" the Vietnam War. It

...was developed to estimate the cost implications of additional deployments...to estimate the cost of various specific force increases and decreases...[to] give us a good approximation of the total

#### 4. NATO Standard Classification:

1. Outlays on military personnel
2. Civilian pay and allowances
3. Other equipment, supplies and operations(part)
4. Procurement of major equipment and missiles
5. Other equipment, supplies and operations (part)
6. Common infrastructure and national construction
7. Pensions to retired military personnel
8. Other expenditures

SIPRI and USDOD classifications also include items separately identified such as R & D, military aid, civil defence, paramilitary forces, space and atomic energy.



financial impact.<sup>5</sup> While standard NATO accounting procedures measured input programs (personnel, fuel, ammunition, spare parts etc.)<sup>6</sup>, the American Vietnam "program budget" was instead designed to measure:

\* "output" programs including "...offensive land operations, border protection, air interdiction, security, pacification and economic development"<sup>7</sup>; and

\* the accompanying financial cost of these operations plus "...the US State Department, the Agency for International Development (AID), the Central Intelligence Agency (CIA), and the like."

The program developed by the Systems Analysis Branch was designed to ascertain the effectiveness of operations per se and to attribute financial costs to these activities.<sup>8</sup> The motives were neither disinterested nor public spirited; the program was aimed at resolving urgent problems for the more effective conduct of war. However, while "... this analysis had no discernible impact on the key decisions"<sup>9</sup>, it did permit a reasonably accurate estimate of the total cost of the Vietnam War to the USA. In 1984, Barbara Tuchman retrospectively estimated these costs at \$US150b, which accords broadly with the accrued official annual figures published during the war.<sup>10</sup> But estimating the costs of war relies not only on such immediate statistical yardsticks as the items included in the cost, the

5. Alain C. Enthoven and K. Wayne Smith, *How Much Is Enough?*, New York, Harper and Row, 1971, p.293.

6. Which were also the Australian Department of Defence's only measures of the costs of its war involvement.

7. Alain C. Enthoven and K. Wayne Smith, *Ibid.*, p.294

8. "It showed vividly that the overwhelming bulk of US total resources was going into offensive operations, (fiscal year 1968 - \$14b. on bombing and offensive operations), with relatively little into population security, pacification, and related programs designed to protect and influence the South Vietnamese population, (fiscal year 1968 - \$0.85b. for pacification and programs designed to offset war damage and develop the economy and social infrastructure in South Vietnam)." *Ibid.*, p.294.

Enthoven and Smith argue that, "Without systematic analysis of resource allocation, the United States tended to dissipate its resources on high-cost, low-pay-off operations that happened to be congenial to traditional Service missions in conventional warfare...More attention to effectiveness in relation to cost might well have led to reductions in the billions of dollars spent on offensive operations and massive firepower displays - activities yielding small returns. Had even a modest part of these resources been used for activities which appeared to have higher pay-offs...the course of US involvement in the war might have been altered sooner." *Ibid.*, p.294. Enthoven and Smith illustrated the impact of costs and benefits on operations by figures attached to the bombing campaign of North Vietnam between 1965 and 1968:

. losses to North Vietnam (capital stock, military facilities, lost economic production) = \$0.6b.

. Communist aid to North Vietnam = \$2.0b.

. American aircraft losses (destroyed) = \$6.0b. *Ibid.*, p.304.

9. *Ibid.*, p.294.

10. Barbara Tuchman, *The March of Folly*, Abacus Books, 1984, p.174.

price basis etc., but also the motivation of the author and the selection of particular figures to back up the desired argument. Another author, describing the same war, assesses the costs to the US at some \$350b.11. But this is going beyond the evidence of expenditure figures into the highly conjectural areas of opportunity cost (dollars not spent, debt, etc.), social cost (such as physical disabilities of veterans) and attribution of costs.

Thus, the costs of war can be measured in several ways: the human cost of lives lost or permanently disabled (first enunciated by Jean-Baptiste Say in 1803, much to Napoleon's chagrin); the financial cost where the national accounts form a casualty list measured in dollars; the damage to property; the distortion of economic development; the loss of exports leading to loss of markets etc. An estimate of the cost depends to some extent on which organisations (eg. it could be a peace research centre like SIPRI) are responsible for measuring these costs and the costs which are selected as attributable to war.

#### 4. Conventional War - Iran/Iraq.

The Iran/Iraq War provides a useful example of aspects of these problems. Iraq initiated the war in September 1980. It did not curtail non-military spending in the early stages and based its projections of national income upon the volume and price of oil exports established after the second OPEC oil price-hike of July 1979. The impact of the war itself on production and export<sup>12</sup>, the oil glut and the officially ordained policy of normality (resulting in few restrictions on non-military expenditure) undermined these premises very rapidly. It was estimated in July

11. James Clotfelter, *The Military in American Politics*, New York, Harper and Row, 1973, p.3. "The final cost of the Vietnam War will exceed \$350 billion - including the continuing burden of veterans' benefits and interest on the national debt." cited in James L. Clayton, "Vietnam: The 200-Year Mortgage", *The Nation*, Vol.208, 25 May 1969, pp.661-3.; however, it would be difficult to determine how much of the public debt, or servicing of that debt, would be attributable to the waging of war let alone one particular war; the national accounts are not required to do so and would have little meaningful impact on future decision-making even were they to be isolated with any degree of confidence. Richard J. Barret, (*The Economy of Death*, New York, Atheneum, 1973, p.41.) estimated the cost of five years of war, in 1969, at \$100 billion, to defend a country (p.42) where the average annual per capita income was less than \$50.

12. For example, in April 1982, Syria closed the Iraqi pipeline to the port of Banias; the cost to Iraq was about US\$5b. per annum.



1986<sup>13</sup>, that the war had cost Iraq some \$US176b by the end of 1985, or some \$90m per day. Along with military expenditure, this figure included estimates of lost GNP and oil revenues.<sup>14</sup> Eventual political and social costs to Iraq included:

- \* A declaration of a policy of economic austerity after April 1982, including cuts in non-military spending;
- \* Restrictions on consumer imports;
- \* Restrictions on the proportion of wages remittable by foreign workers;
- \* Rapid depletion of foreign reserves<sup>15</sup> alongside a steadily accumulating burden of debt. These amounted to some \$50b. in government debt and some \$15b. in private sector debt by 1986; annual debt servicing reached \$3b. in 1986.<sup>16</sup> (In comparison, the Australian Commonwealth Government's current debt service is in the region of \$A8b. or \$US6b annually - without the cost of a war).

Two other effects of the cost of war on Iraq are particularly noteworthy. Firstly, the war with Iran consumed nearly all of its foreign reserves. Instead of having invested its earnings from petro-dollars in productive economic enterprises ensuring a real rate of return, Iraq instead squandered its assets in a war of stalemate without the benefit of a victory to balance the cost sheet. As a result, Iraq's strategic future (measured in economic terms) will be less influential than had it not gone to war at all. Secondly, the accumulation of foreign debt has now put a subtle limit on the country's independence and restricts to some extent the pursuit of a fully-independent foreign policy.<sup>17</sup>

13. A. Alnasraivi, "Economic Consequences of the Iran-Iraq War", *Third World Quarterly*, vol.8, no.3, July 1986, p.885.

14. It was estimated that the direct military costs of the war to Iraq were in the region of \$US94-112b., *Time Magazine* of 19 September 1988, p.68.

15. Foreign reserves were estimated at some \$US30b. before the war but only \$US6b. by late 1982; *Canberra Times* of 6 August 1988, "Eight years of the Iran-Iraq war".

16. Ralph King, "The Iran-Iraq War: The Political Implications", *Adelphi Paper* No.219, International Institute for Strategic Studies, London, Spring 1987, p17-18., Iraq's foreign debt was estimated at some \$32-40 billion in April-May 1985 and its credit-worthiness at 20.0; see Peter Korner, *The IMF and the Debt Crisis*, London, Zed Books, 1986, pp.10 and 23. Iraq's foreign debt was estimated by *Time Magazine* on 19 September 1988 at \$US30-40b. from Arab countries like Kuwait and Saudi Arabia and another \$US25b. to European and Asian creditors. The *Sydney Morning Herald* spoke of foreign debts to the tune of \$US40b.; (see "Iran and Iraq prepare to count the costs of war," of 23 July 1988. The author, Youssef Ibrahim, refers to a highly skilled and educated population of 14-15m. people with considerable natural resources.

17. The Commonwealth Treasurer, Mr P. Keating made this point when redeeming \$A815m. of foreign debt in West Berlin 1988. "He said paying the Commonwealth's debt over time would strengthen Australia's sovereignty by



Iran began the war with higher foreign reserves than Iraq but was more dependent on both imports, and on oil exports as a source of revenue to pay for those imports. Like Iraq, Iran exaggerated its projections of future income on the high oil revenues of July 1979. Failure of these predictions to eventuate led to drastic steps by the government:

- \* Reduction of imports not essential for the war effort;
- \* Extensive purchases of arms on the open and black markets;
- \* Increased dependence on imports and oil exports to raise revenue (exacerbated by inept planning in industry and agriculture).

The war was estimated to have cost Iran \$US240 billion to the end of 1985; the official Iranian figure at the end of 1986 admitted to \$US309 billion.<sup>18</sup> These translated into a daily expenditure figure of some \$US125-135m.

As with Iraq, the war has been detrimental to Iran's future. It has lowered foreign reserves and the value of its overseas assets, it has created a modest foreign debt (from a huge pre-war surplus), and set back the oil industry at the same time as it has increased the country's dependence on oil exports to survive.<sup>19</sup> In short the country, in aggregate, is the poorer for being at war and its future as the "policeman" of the Middle East almost irreparably damaged.

##### 5. Limited War - The Falklands War.

In his book, *The Causes of War*, historian Geoffrey Blainey listed some of the conditions (as judged by the appropriate contemporary power elites) that would propel a country into

---

cutting interest payments that have burdened the Budget for more than a decade." *The Australian*, 28 September 1988).

18. Of this total, *Time Magazine* estimated that direct military costs amounted to some \$US74-91b., (*Time Magazine*, 19 September 1988, p.68).

19. K.McLachlan and G. Joffe, *The Gulf War: A Summary of the Political Issues and Economic Consequences*, London, Economist Intelligence Unit, 1985, p.38, cited in Ralph King, *The Iran-Iraq War: The Political Implications*, Adelphi Papers No.219, International Institute for Strategic Studies, London, Spring 1987.

war.<sup>20</sup> This paper would emphasise that in economic terms, war should be cost-effective and efficient<sup>21</sup>. Yet the preparations for, and conduct of, conventional war have now reached such monstrous proportions of financial cost (except when compared to most countries' overall borrowings), and the results so fraught with risk (defeat) or compromise (negotiated solution) that war has become an activity difficult to justify economically. Therefore, war is certainly a policy of last resort in narrow economic terms.

The 1982 War for the Falklands/Malvinas Islands exemplified these cost trends. In May 1982 the Argentine junta confidently estimated the war-related costs to the country at no more than \$US20m.<sup>22</sup> Argentina's creditors, apparently using different criteria of measurement, estimated the cost to the country at some \$US500m.

The British also put effort into estimating the costs of that country's operations to regain the islands.<sup>23</sup> During the conflict several UK stockbroking firms<sup>24</sup> estimated that net additional costs to the country would be between 250m and 1500m pounds. The war effort was then costing some 11-12m pounds per day so the final expenditure figure depended on the expected duration of the war. The idea of net additional costs was made problematic because of:

20. A war is feasible when it is considered it will be short, popular, victorious, inevitable and cost-effective; Geoffrey Blainey, *The Causes of War*, Melbourne, Sun Books, 1977. He notes that the protagonists of 1904 and 1914 were influenced by assessments of the others' ability to finance a war. Blainey also relates the following anecdote: "When Japanese leaders debated in 1873 whether to invade Korea the main architect of modernisation, Okubo Toshimichi, opposed the invasion by listing seven arguments. Five of his seven points stressed the financial implications of the proposed war, ...inflation ...high taxes ...scarcity of funds for modernising her schools and industries ...raised expenditures ...troubled to balance her budget. If the war proved to be long or unsuccessful, 'our inability to repay our debts to England will become England's pretext for intervention in our internal affairs'".

21. Indeed, the apparent poverty of military inspiration and the huge financial costs of the war eventually determined the direction of the course of the war. After 1983-4, each side's diplomatic, military and political war effort was concentrated on destroying the other's ability to finance the war - to halt the oil exports on which so much of the revenue to pay for the war was based. *Time Magazine* reckoned that oil was responsible for more than 90% of both countries' foreign-exchange earnings, see *Time* of 19 September 1988, p.68.

22. *The Economist*, 29 May 1982, p.14.

23. *Guardian* article reprinted in the *Sydney Morning Herald*, 7 May 1982.

24. See footnote no.15: Greenwells Stockbrokers - 250m pounds; Hoare Govett Stockbrokers- 750-1500m pounds; James Cepel Stockbrokers - 11-12m pounds per day. These were net additional costs to run the war effort.



- (1) Estimating, and then deducting, the "sunk" costs of routine, planned maritime exercises for the same period;
- (2) Estimating whether the government would replace its lost destroyers with vessels of the same kind, cheaper or different ones, or more modern and/or more cost-effective ones; and
- (3) Estimating the revenue return to Treasury (about 20% of additional war expenditure) from increased taxes and lower unemployment benefits, both occurring as a result of extra defence activity.

"After the battle, the accounting..." wrote *The Economist* on 19 June 1982, five days after the Argentine decision to cease military operations. The article split the costs attributable to the war into four categories:

- (1) Unavoidable additional operational expenses for the 1982-3 financial year; fuel (60% of total additional operating costs), extra spare parts and supplies, requisitioning, converting and running the 50-odd merchant ships: total cost 500m pounds;
- (2) Replacing lost equipment and ammunition (10 Harrier jump-jets, over 20 helicopters); making up for battlefield wear and tear: total cost about 400m pounds;
- (3) Major capital costs of replacing four destroyers and frigates, and two amphibious ships: total costs about 600m pounds; and
- (4) The ironic cost of victory - maintaining a permanent garrison in the Falklands: about 3000 soldiers, a squadron of fighter aircraft, helicopters, anti-aircraft missile batteries and early warning equipment; total cost: one-off set-up, about 50-500m pounds depending on make-up plus annual running costs of 100m pounds.<sup>25</sup>

Subsequent to the actual conduct of operations the accrued costs of the war rose with the UK's accumulated responsibilities: in June 1982, 1.6b pounds to 2.0b pounds; in November 1984, 2.1b pounds; in February 1987, 2.6b pounds.<sup>26</sup>

25. This paper has addressed the costs of what actually happened, which is that in 2 months British forces regained the islands. Of course, if the British had acquiesced in the Argentine seizure the itemised cost of destruction and operations would have been saved but at a strategic cost which cannot be measured by the same criteria.

26. *The Economist*, 19 June 1982: 1.6 to 2.0 billion pounds for the campaign and its aftermath. *Janes Defence Weekly*, 24 November 1984: 2.1 billion pounds for total war costs (\$US2688m) or 1m pounds for each inhabitant of the islands from 2 April 1982 to end FY 1984. *Janes Defence Weekly*, 7 February 1987: 2.6b pounds at 1987 prices - including: 1. replacement equipment, 2. maintenance of a garrison on the islands, 3. air bases, 4. transport and posting costs - these costs comprised 400m pounds or 2% of the 1987 British defence budget.



Concomitant with the estimate of the costs of the war were the means - and problems - of paying for it. The actual war was over before long-term financing even became a concern. Short-term options were as follows:

- \* Increase defence spending to cover Falklands costs, but account for them separately from routine defence spending;
- \* Squeeze operational/replacement costs of the Falklands from existing defence budget allocations; ie. internal Defence reallocation of priorities;
- \* Do without some replacement equipment - a possible Treasury argument;
- \* Institute a one-off special war tax for the next budget;
- \* Issue "Falklands bonds";
- \* Provide smaller tax-reductions in the next budget (assuming these are on the agenda);
- \* Let the Falklands costs nudge up government borrowing as a proportion of GNP (ie. increase the public sector borrowing requirement); and
- \* Public subscription.

There were a series of problems associated with raising war finance. Firstly, taxation would be unpopular politically and deflationary, that is, it might withdraw liquidity from other areas of the economy. Secondly, funds especially raised were unlikely to be spent in the short-term; many of the funding requirements stemmed from capital equipment replacement which, since it was unlikely they could be replaced within a budgetary year, would not create final billings for several years (ie. after build or construction). Thirdly, to launch a specially designated bond-drive (ie. "Falklands bonds") could induce public humiliation if the required amount was not reached.<sup>27</sup>

The Economist recommended that

...to ensure that the Falklands costs do not chisel away at Britain's security [it] will be [necessary] to pay for them directly from the overall budget, but to account for them separately from routine defence spending, at least until the major capital costs are paid.<sup>28</sup>

The bills should be spread over three or four years with a line

---

Costs in the 1990s were estimated to be about 100m pounds per annum.

27. "The memory of long-unredeemed war bonds after the second World War could well dissuade buyers". The Economist, 19 June 1982, p.40

28. The Economist, 19 June 1982, p.40

item to identify the "Falklands increment". The advantages associated with this approach were, inter alia, a modest increase only in public spending and borrowing, protection of "basic" defence spending and hence security; public accountability; the recognition of "tax clawback" in the national accounts because of the extra revenue generated by capital equipment replacement.

Therefore, in the present age of limited warfare and potential

## 6. Australia - Exercise Kangaroo 89.

follow. A viable financial response to conflict must fall

Exercise Kangaroo 89 was designed to test the "strategic and operational concepts identified in the 1987 Defence White Paper."<sup>29</sup> It also indicated the costs which Australia might face in providing for a "range of credible defence contingencies which could arise with little or no warning in Australia's area of interest."

Involving more than 25,000 ADF personnel, 30 naval ships and submarines, 2000 vehicles and some figure less than 100 aircraft the exercise lasted some 60 days, from mid-July to mid-September 1989. This "most ambitious, wide ranging and significant exercise" was costed at some \$A200-250m or an average of some \$4m per day.<sup>30</sup> However, half of this was accounted for by wages and salaries which would have been paid regardless. The incremental costs, such as those for fuel, overtime, repair etc. were the true cost of the exercise. Assuming the lack of live firing cancelled out the subsumed cost of other exercises which were incorporated into Kangaroo 89, then the figure of \$100-150m for about 30-40 days fairly intensive activity might be an approximate cost of operations to Australia in a contingency.<sup>31</sup>

29. Ministerial Statement No.202/88 dated 8 November 1988.

30. See Australian Society, "The Kamarians are coming", June 1989, pp.18-20. This stated the cost at \$230m.

31. The other 20-30 days were accounted for by transport movements, setting up and winding down costs. Therefore, the standard statistical spread of direct, additional costs over this period could mean costs peaking at some \$5-6m per day. Costs also excluded replacement of destroyed capital equipment, compensation payments, destruction of facilities etc., which were borne by the British after the Falklands War. Also, it is not clear which contingency is being represented or tested in the exercise; a contingency which is supposed to arise with little or no warning should be low level but the exercise includes a lodgement on Australian territory. Therefore, it can be safely assumed to have escalated; but in an exercise which escalates so quickly and is so quickly resolved one could be tempted to question its realism and the overall costs, direct and indirect, to Defence, the government and the Australian economy.

Since 1945, Australia has not needed to develop a financial policy for defence contingencies; nor has it had to confront the constraints on other public policies which the costs of war might induce. Its financial war experience has been based on the needs of total war only and this largely from the structural adjustments and institutional innovations of WW 1, with improvements and modifications stemming from the second.<sup>32</sup> Therefore, in the present age of limited warfare and potential nuclear strike, there are no strict precedents for Australia to follow. A viable financial response to conflict must fall someway between the experience of total war, exemplified by the writings of Robbins, and the theoretical underpinnings set out in Keynes, where the primacy of economic policy is retained during small wars.

Nevertheless, the exigencies and sheer costs of war have had a major impact on the nature and structure of the Commonwealth's public finances. Firstly, in 1914, the Commonwealth won the right to levy its own income tax along with the States. Secondly, in 1942, the States were excluded altogether from raising revenue via direct income taxation.

It would be unlikely that the financial measures attending a contemporary foreseeable defence contingency would have anything like the same effect as these structural adjustments, but financial disruptions might still be considerable, for reasons that did not apply in either of the two world wars but which have assumed major significance in recent times (see Chapter 3).

Most of the Commonwealth's efforts in financial policy for funding war have been directed into two channels:

\* Firstly, to underwrite the nation's mobilisation of its resources in matters such as industrial production, labour, transport and communications etc.; and

32. G. Long, *The Six Years War*, Sydney, the Australian War Memorial and the Australian Government Publishing Service, 1973, p.12. "These problems had arisen and been grappled with in 1914; now the Government mainly followed precedent or improved on it."



## CHAPTER 4: AUSTRALIA — WAR AND CONTINGENCY FINANCE

### 1. Introduction

The Australian experience of financing war has largely been confined to the two total, declared wars fought this century. There has been no corresponding experience of Australia conducting a limited war which has had some degree of impact on the institutional structures and arrangements of the body politic, and therefore there has been no necessity for the government to have prepared a financial policy for such a contingency. This deliberate oversight was specifically recognised in the 1986 Dibb Report but excused on the grounds that, "No specific threat is imminent or obvious that would justify undertaking detailed planning in this area."<sup>1</sup>

Nevertheless, the exigencies and sheer costs of war have had a major impact on the nature and structure of the Commonwealth's public finances. Firstly, in 1915, the Commonwealth won the right to levy its own income tax along with the States. Secondly, in 1942, the States were excluded altogether from raising revenue via direct income taxation.

It would be unlikely that the financial measures attending a contemporary foreseeable defence contingency would have anything like the same effect as these structural adjustments. But financial disruptions might still be considerable, for reasons that did not apply in either of the two world wars but which have assumed major significance in recent times (see Chapter 5).

Most of the Commonwealth's efforts in financial policy for funding war have been directed into two channels:

- \* Firstly, to underwrite the nation's mobilisation of its resources in matters such as industrial production, labour, transport and communications etc.; and

<sup>1</sup> Review of Australia's Defence Capabilities, Report to the Minister for Defence by Mr Paul Dibb, Australian Government Publishing Service, Canberra, p.94.

\* Secondly, financial policy *per se*, which has involved for example, raising loans and controlling prices, and the impact the chosen financial policy has had on external trade, taxation, financial relations between the Commonwealth and the States etc., which are notoriously affected by government financial policy.

The second of these is the focus of this chapter (and thesis) and is more relevant to the present age of limited wars than the first, which really applies to a nation "at war" in the traditional sense as it evolved between 1793 and 1945.

## 2. World War 1

The *Official History of Australia in the War* remarked that,

The real seriousness of the war, its duration, the huge financial drain, with the shifts and expedients it would entail, were all under-estimated, alike by public men and by the people at large,... financial derangement was part of the terrific confusion of all things.<sup>2</sup>

The actual financial costs to Australia were wildly underestimated in 1914. The Fisher Government, starting with a balance of payments deficit the previous 1913-14 financial year (F/Y), estimated the war would cost 11.7m. pounds in F/Y 1914-15, at the end of which, it was predicted, the war would be finished. By F/Y 1919-20 the cost to Australia was put at 377m. pounds, and still rising.<sup>3</sup> The point was made that one year of war [F/Y 1918-19] cost Australia 81m. pounds when its population was only 5m., whereas 3 years of war in the Crimea cost the UK 78m. pounds when its population was over 27m.

For the duration of the war, public finance was divided into

2. Ernest Scott, *Australia During the War*, Vol.XI of the series "The Official History of Australia in the War of 1914-1918, Sydney, Angus & Robertson Ltd., 1943, p.495.

3. As Adam Smith could well have predicted 150 years before, the financial costs of the war to Australia were enormous. When looking at the figure of 377m. pounds one has to keep in mind that the total revenue for Australia's seven governments in 1914 was only 69m. pounds (Commonwealth, 21.7m. pounds, and the States, 47.1m. pounds). The costs of the war were:

(1) direct expenditure by Australia, 333.6m. pounds,

(2) charges by the British Government on provision of services to Australia, 43.4m. pounds.

Nearly 80% of the cost borne by Australia was financed by borrowing. The costs of the war did not cease in 1919. "Expenditure on repatriation and pensions was a direct consequence of the war, and that continued to be a very heavy drain upon the finances of the Commonwealth in later years. The total cost to 30th June, 1934, had reached the figure of 831.3m. pounds, inclusive of war gratuities, interest and sinking fund." *The Official History*, Vol.XI, p.496. It is worth remarking here that in 1908 (before absorbing the States' public works debts) the Commonwealth had no public debt and had seriously entertained the proposal that defence should be paid for from the surplus of the Commonwealth's land tax.

three areas:

- (1) War expenditure;
- (2) Money required for renewing obligations, ie. converting current loans; and
- (3) Money required for new works and other services (which continued in spite of the war - these formed a point of tension between the Commonwealth and the States).

The key point here is that war expenditure is additional to the routine expenditure and obligations already incurred by the Commonwealth government. While non-defence spending can be slowed or discouraged, it nonetheless, will and must continue. To some extent then, the level of financial commitment in place at the outbreak of war (or contingency) will determine the amount of funding which can be devoted to the war effort and, to some degree, the sort of war which can be fought.

Several dominant policy issues arose during the course of the war and were constantly addressed. The first concern was how to actually pay for the war<sup>4</sup>. In 1914, the Government quickly realised that estimates of current revenue would be hopelessly inadequate to cover the war's expenses.<sup>5</sup> The initial estimates of 11.7m. pounds were therefore to be raised entirely by borrowing in the first instance, and taxes were to be raised in the event of the war continuing. New taxes were raised progressively throughout the war years - increase of the land tax (1914), Commonwealth levy on income tax (1915), an entertainment tax (1916), war-time profits tax (1917)<sup>6</sup>, a tax on bachelors not in uniform (1917), and finally and most drastically, compulsory loans (1918).<sup>7</sup>

The second key issue concerned who was to pay for the war. Unlike present arrangements, all seven Australian Governments

4. The war saw seven war loan and three peace loan campaigns. These raised some 250m. pounds from the Australian people, who invested in the government's stock and bond issues.

5. "...I gave up the cherished hope of financing our war forces on sea and land, in the Pacific and in Europe, during this financial year [1914-15], from revenue...", op. cit., p.481, quoting Fisher, the Prime Minister from the Commonwealth Parliamentary Debates, Vol.LXXV, p.1341.

6. The amount by which the profit in the war years from 1915 onwards exceeded the average profits of certain years. The rate of tax for 1915-16 was 50%; for subsequent years 75%.

7. The War Loans Subscription Bill of 1918; the war finished before it could become law. A similar prescription for paying for war was raised by Keynes in 1939 and rejected by the Labor Government in WW II.



then raised expenditure from both direct and indirect taxation but only the Federal Government was entitled, and obliged to fund the war effort (by the Constitution and the division of responsibilities established in 1901). In the early war years the revenue of the Federal Government represented only some 25% of the total revenue raised in Australia although this rose to nearly 40% by F/Y 1918-19. Throughout the war there remained considerable tension as the States continued to fund public works programs and borrowed for that purpose. "No State government showed any resolute tendency to economise"<sup>8</sup>, and in July 1918, the Federal Treasurer added a warning to the States, "You cannot go on indefinitely increasing your indebtedness."<sup>9</sup>

The nature of Australian federalism is such that patriotism might be insufficient to quell the traditional and perennial financial disputes between the Commonwealth and the States. In the event of military conflict, a formula would probably have to be settled which allowed for consensus on borrowing and spending requirements for all the Australian governments. The Commonwealth would be unlikely to relinquish its monopoly of the right to tax incomes directly.

The third concern involved problems with raising and competing for loans on the money-market. In November 1915 it was decided that the States should be restricted to domestic borrowing and only the Commonwealth could raise funds overseas. Furthermore, the States were not to borrow locally until the Commonwealth's war needs [for funds] were met.

Similar problems to these would likely arise again to plague the financial management of a defence contingency. The Commonwealth Government would then have to address issues such as the borrowing requirements of all the Australian governments, costs borne in the event of hostilities, attribution of costs, the levying of charges to defray those costs, special one-off grants

8. *The Official History*, p.483.

9. In 1910 the public debt of the Commonwealth stood at zero; in 1911, at 6m. pounds; in 1914, at 19m. pounds; in 1919, at 263m. pounds. The latter rise was due almost entirely to WW 1. At the same time, the aggregate debt of the Australian States grew from 317m. pounds in 1914 to 417m. pounds in 1919 and they did not contribute to the costs of the war.

to the States to meet emergency spending etc. The degree of cooperation could even be undermined by the apparent, possible lack of seriousness of the conflict and the reluctance of both the public and the States to accept strictures which they might otherwise tolerate in a clearly defined war.

### 3. World War 11.

As for WW 1, the initial estimates of war expenditure understated the costs of the war to Australia. The figure of 79m. pounds for F/Y 1940-41 (the first financial year to be fully occupied with a state of declared war) rapidly grew to 186m. pounds. This included 43m. pounds for war expenditure overseas.<sup>10</sup> The raising of finance for the domestic component of 143m. pounds is set out in the following figures: (they also serve to illustrate the ultimate accounting fate of the practical aspects of the theories and policies outlined in this thesis):

* Existing cash balances -	28m. pounds
* Existing taxation -	34m. pounds
* Public borrowing -	50m. pounds
* Additional taxation measures -	31m. pounds
(sourced in):	

a. income tax -	17.7m. pounds
b. company tax -	5.8m. pounds
c. sales tax -	3.4m. pounds
d. customs	
and excise -	4.2m. pounds
	= 31.1m. pounds

Total: 143m. pounds

To raise these sums, the government had recourse to the two basic options of borrowing and taxing. In November 1940, the Treasurer stated that,

Expenditure in Australia...on war...must come in some way from the pockets of the people. It may come by loans, where a man willingly gives up spending power in the present in return for spending power in the future. It may come by a system of taxation designed to take from each man according to his ability to pay. It may come by expansion of credit whereby spending power is taken from the community by rising prices...<sup>11</sup>.

10. This was raised by government borrowing from the Commonwealth Bank. The expenditure was paid for eventually from a continuing favourable balance of trade, stemming largely from wartime restrictions on imports and a steadily increasing demand for Australian exports.

11. Commonwealth Parliamentary Debates, Vol.165, p.83, 21 November 1940. Keynes had already warned of the



The Treasurer ruled out expansion of credit [as inflationary].<sup>12</sup>

We are left with two implements, borrowing the savings of the community and taxation. Loans will depend on the willingness and capacity of the people to save, and may be increased by organised effort, particularly through war savings certificates [as in WW 1]. Whatever can be done in these ways will leave a very large gap to be filled by additional taxation.<sup>13</sup>

In the short run, the government showed a reluctance to tax for war purposes, not wanting to discourage private investment and activity from its pursuit of the war effort. Financial policy was to be achieved in two stages. Firstly, an immediate program of financing the war by loans, when the economy would be undergoing considerable dislocation as it moved onto a war footing; and secondly, a long-term plan relying more on taxation.<sup>14</sup>

Dominant financial issues which led into policy<sup>15</sup> were:

---

inequity of this last course of action, or inaction.

12. Inflation has always been the threat which has bedevilled the funding of wars: "it imposes unjust and inequitable financial burdens upon the wage and salary earner, it destroys public confidence, is destructive of savings...", *Commonwealth Parliamentary Debates*, Vol.163, pp.6-7, 17 April 1940, statement by the Treasurer.

13. In contrast, the Labour Treasurer (Chifley) in October 1941 said, "Credit expansion...can be successfully used to finance employment...to expand production of goods and materials...(but) any increase of the money volume must be balanced by a corresponding increase of production." *Commonwealth Parliamentary Debates*, Vol.169, p.21, 29 October 1941. Labour also rejected compulsory loans (although Keynes had maintained that these would equalize the sacrifice of financing the war). Instead, money would be raised by increased taxation and direct control of the economy by government regulation. Thus Robbins' criticism of Keynes' theory of war finance was borne out by the Australian experience of WW 1; that "...it is a theory which no government has ever had the will to make the effective basis of policy in a war of any great dimension." in *The Economic Problem in Peace and War*, p.32.

14. "...the government has decided that, in distributing the cost of its war programme between taxation, public borrowing and borrowing from the banking system, it will...weight the balance towards borrowing with the assistance of the banking system rather than towards taxation...; to increase taxation [now] would merely delay the recovery of our economy, retard the full utilisation of employable labour, reduce the potential of our national income, and consequently interfere with the full prosecution of our war programme... When our resources are as fully employed as is practicable and our "real" national income at its peak, borrowing should not exceed the savings of the people available at any time. Any additional requirements should be drawn from taxation..., as the economic recovery...gets under way, the government will necessarily transfer the emphasis in its financial policy from borrowing from the banking system first to borrowing from the public and secondly...to taxation." *Commonwealth Parliamentary Debates*, Vol.162, pp.1851-2, 30 November 1939, statement by the Treasurer.

15. There was also a strong link between financial policy and the law. Many of the measures undertaken by the Commonwealth Government between 1939 and 1945 were carried out under the auspices of the National Security Act of 1939 and the Defence Act. The semi-official history lists the following as financial powers assumed under these Acts: (1) prevent Australians from sending capital overseas; (2) all proceeds from exports were directed into the banking system and thus made subject to government control; (3) Australians were [later] prevented from selling securities held abroad so as to obtain foreign currency; (4) the control of exchange was completed by the introduction of regulations requiring importers to obtain permission before bringing in imports from non-sterling areas. See, G.Long, *The Six Years War*, Sydney, the Australian War Memorial and the Australian Government Publishing Service, 1973, p.12.



(1) Control of private investment - to conserve resources for the war effort;

(2) Low interest rates (set at August 1939 rates) - to stimulate private investment in selected war-related industries;

(3) The issue of war savings certificates - to promote investment in the war effort by small investors or individuals of limited means; and

(4) Treasury control of defence expenditure.

After the initial phase of borrowing heavily for war purposes, the Commonwealth resorted to the next phase of heavy taxation. The level of taxation increased with the intensity of the war, especially as it approached Australia's geographical perimeter.<sup>16</sup> Nevertheless, costs were such that borrowing still accounted for two-thirds of the payments for the war. Borrowing comprised three forms:

(1) Public loans (from the people in the form of investment in Government bonds, notes, securities etc.);

(2) War savings certificates (similar to public loans but targeted for war purposes); and

(3) Loans from the banking system.<sup>17</sup>

The experience of Australian financial policy in the Second World War was largely a repeat of the principles borne out in the First. Therefore, taken together, they have more in common with each other (eg. events, scale costs, involvement etc.) than they do with the present day which requires the adaptation of policies to fit the possibilities of limited war in the nuclear age.

#### 4. Applicability of Total War Experience to the Present.

The economic principles which underlay the waging of total war in 1914-18 and 1939-45 are still largely relevant now (they

16. Income taxes went from 16% of Commonwealth revenue in 1938-39 to over 60% by the end of the war.

17. In November 1939, the Treasurer stated that "...the financial policy of the government is to finance the war effort by a balanced programme of taxation, borrowing from the public and borrowing from the banking system." Commonwealth Parliamentary Debates, Vol. 162, pp.1851-2, 30 November 1939.

still form the base of the central role of the government in the current nation-state, eg. Federal Government control of monetary policy) but the financial aspects and mechanical processes of the systems which were responsible for funding them are now almost totally redundant.

Similarities are primary but few:

- \* The roles and identities of the key financial and institutional players are much the same, as are the main policy tools available, eg. taxing and borrowing.
- \* The right of the government to interfere in the workings of the economy is established by law and precedent, regardless of the nature and scale of the conflict.

Differences are secondary but many:

- \* The multiplication of financial players (eg. the international investment community, the recent proliferation of investment groups) with strong vested pecuniary interests at the time of the contingency;
- \* The drastic effect of technology and modern communications on the policy-making environment; the compression of time has restricted the decision-making process and made the consequences of decisions that much more immediate.
- \* The endemic and pervasive role of the media.
- \* The relegation of the gold standard and the once stable global exchange rate regime; the Australian economy is now subject to increasingly unstable exchange rate gyrations.
- \* The novel scale of domestic and foreign debt since 1985; this limits the financial options and flexibility available to the government.
- \* The rapid change in the definition and nature of national security; financial and economic policies are no longer the mere bottom-line of an otherwise political and military-oriented defence policy. Finance can be a valid and efficacious tool of defence and foreign policy<sup>18</sup> or it can be, in debt form, the "Achilles' heel" of a nation's security posture.<sup>19</sup>

18. A good example is the Japanese penetration of the Pacific region since 1977 under the Kuranari Doctrine, a highly effective form of financial imperialism.

19. Recent statements by commentators have become both more frequent and more pointed: (1) *Time*, 24 April 1989, quoting Les Aspin, Chairman of the US House Armed Services Committee, "What we're seeing is the emergence of an entirely new concept of national security" and Clyde Prestowitz, a former US trade negotiator, "Trade is defence." (2) *Sydney Morning Herald*, 27 May 1989, quoting Dr. Kenichi Ohmae at the



5. Planning for the Next War. above judgement. It rejected the need for an updated "war book" approach to defence planning.<sup>19</sup>

In the changed circumstances of the present day, defence planning processes for contingencies might well be as valid as the collective experience of war finance was before 1945. But neither planning nor experience has witnessed a viable and strategic role for finance beyond its supportive function.

#### (a) The War Book

The 1939 War Book was designed as the co-ordinating instrument of policy for Australia's economic preparations for war. Not total war apparently, because it planned "...to cause the least possible dislocation in the normal economic life of the Commonwealth," and "...deliberate restriction of consumption was not envisaged, unless it could be read into the financial arrangements."<sup>20</sup> Details of financial policy and planning were general and consisted of little more than homilies for Treasury to continue to fulfil its role and for the Commonwealth Bank (then the Central Bank) to be consulted.<sup>21</sup> The *Official History* was almost dismissive of the War Book's financial aspects: "...there was nothing...to suggest some idea of a financial plan," and "...the War Book had virtually nothing to say about the economic problems of war except where they appeared likely to be the same problems as those of the earlier war."<sup>22</sup>

conference organised by the Committee for Economic Development of Australia, "...the spread of information and of global companies meant that the world increasingly was becoming a 'borderless economy' and that you no longer needed the military to take over another country. (3) *Sydney Morning Herald*, 1 June 1989, quoting Dr. Robert Haupt, "...our sovereignty is already compromised...our security depends, in the end, on maintaining our relative economic position: it is not now compromised, but..."

20. S.J. Butlin, *War Economy 1939-1942*, Sydney, Halstead Press, 1961, p.26.

21. Finance consisted of two sections: (1) voting and provision of money (fiscal policy), and (2) support of credit (monetary policy). Treasury's fiscal responsibilities were to:

(a) consult departments concerned as to immediate requirements for war finance and obtain the necessary Parliamentary authority;

(b) prepare a War Loan Bill and consider arrangements for temporary borrowing;

(c) review Budget position and consider reduction of unessential expenditure and increase of taxation;

(d) arrange meeting of Loan Council;

(e) consider appointment of War Finance Committee; and

(f) consult with Commonwealth Bank as to finance generally.

Treasury's monetary responsibilities were to:

(g) consult with the Commonwealth Bank; and

(h) ascertain from Dominions Office action being taken by British Treasury.

22. *Op.cit.*, p.27.



The Dibb Report confirmed the above judgement. It rejected the need for an updated "war book" approach to defence planning.<sup>23</sup> Instead, Dibb suggested broad guidelines "...to provide a basis for military planning and exercising." The guidelines stated that:

\* The ADF would only respond to an overt military threat; and

\* Normal administrative procedures and systems would be retained while recognising the need for some streamlined procedures to ensure defence needs were met.

However, the Report did not take the next step, the examination of possible policy responses to non-military threat, or a non-military response to a military threat, and did not address the administrative procedures which were not immediately concerned with supporting defence (ie. read "military") concerns. In fairness to the Dibb Report, this is not the responsibility of defence policy as currently defined.

#### (b) Defence Contingency Planning<sup>24</sup>

Australian defence contingency planning arose as a result of a sequence of historical events in the early 1970s when "... the perceived threat of communist or Asian expansionism receded...", and was replaced by "...potential threats to Australian interests short of invasion or major assault."<sup>25</sup> Contingencies are now developed, in the absence of war and historical experience, in the absence of contemporary manifest threat and of clear strategic guidance, to fill the gap created by peace. They are "... to provide a nation with effective defence... [by]

23. "We need a conceptual framework rather than detailed planning of the kind contained in the War Book." Dibb rejected it for two reasons: (1) the next conflict involving Australia might never be declared; and (2) the conflict may not require the total commitment of the nation's resources. See the Dibb Report, pp.94-96.

24. To minimize future strategic uncertainty, contingencies have been introduced into the defence planning process. But, their prediction of events is arguable and they rely on an extrapolation of current and likely trends. The only two definite aspects of contingencies are: (1) they will happen in the future; and (2) they will certainly add to the costs of the economy and the government. Contingency funding is one of the most reliable and "knowable" tools the defence planner has, yet it appears to be unutilised. In the 1981-82 fiscal year, the British Government had set aside 2.4b pounds for contingencies (not necessarily for war-related emergencies; common contingencies include pay rises, unexpected procurement bills etc.) and flexibility to borrow up to 2 billion pounds as well before its economic policies for that year were breached. These contingency funds amply covered the costs of the Falklands "contingency".

25. T. Godfrey-Smith, *Low Level Conflict Contingencies and Australian Defence Policy*, Canberra Papers on Strategy and Defence No.34, Strategic and Defence Studies Centre, Canberra, 1985, p.1.

identify[ing] the range of threats that could arise and [by] allocat[ing] priorities for defence planning."<sup>26</sup>

Contingency definition and planning reached their public apotheosis in the 1986 Review of Defence Capabilities (known commonly as the Dibb Report) and the subsequent Defence Policy Information Paper (referred to as the White Paper) of 1987. These rounded off nearly two decades in the evolution of a more domestically oriented strategic outlook. Prior to these statements of policy, three conflict levels had already been identified: low, middle and high. Each level had a distinct set of adjectives or phrases which categorised it: low level was "at short notice, most likely, most credible" etc.; the next level was "escalated, protracted", while the highest level was "more substantial, limited lodgement, sustained" etc.<sup>27</sup>

The Dibb Report attempted to placate the intense semantic controversies surrounding these horizontal bandings by choosing escalated low level (middle) as the compromise middle-ground for force development. The White Paper defined these levels of conflict for internal defence policy purposes as follows:

**\* Low level** - characterised by "...relatively modest military effort [on the part of the enemy]", "to demonstrate Australia's vulnerability", "force political concessions", "dispersed and unpredictable", "unconventional tactics and forces...".

**\* Escalated low level** - "...more conventional but still limited military operations", "supplement or substituting unconventional tactics and forces with military units", "international repercussions...".

26. R.Babbage, *Managing Australia's Contingency Spectrum for Defence Planning*, Working Paper No.108, Strategic and Defence Studies Centre, ANU, Canberra, 1986, p.1.

27. A typical example is the following: "Primarily, there is the low level threat to the coastal areas and off-shore waters of northern Australia. This could arise at short notice, but would be limited in size and of a harrassing [sic] nature. This low level conflict could escalate and involve increased levels of harrassment [sic] by air and sea on northern settlements, shipping, off-shore territories and installations, mining of northern ports and more frequent and intensive raids by land forces. Such an escalation implies a significant level of military commitment by a hostile country and would almost certainly be preceded by a lengthy period of unpleasant diplomatic exchanges. However, the capability to mount such a threat with little warning exists in our region and our force-in-being must be able to counter it." Major-General J.D.Stevenson, "Is the defence force effective?", *Pacific Defence Reporter*, 1989 Annual Reference Edition, Peter Isaacson Publishers, p.227.



\* More substantial - "...high level intensive military operations", "major ground forces", "military expansion with external support or assistance..."<sup>28</sup>.

These contingency levels reflect the broad and public basis of much of current defence policy known as "self-reliance".

There are, however, a number of limitations which need to be recognized and which are highlighted by the continuing absence of financial dimensions, among others, from the planning process. Firstly, the danger for contingency planning is that it will remain estranged from strategic guidance. The latter records the continued absence of military threat to Australia (acknowledged by successive official strategic documents, all of which have received Government imprimatur), whereas the former looks at the possible course of military conflict in the region, based on forces-in-being.

Secondly, the plethora of political issues which will presumably give rise to the contingency in the first place, provide it with its rationale, govern its likely course, and be instrumental in determining its conclusion, will be absent from the contingency plan.<sup>29</sup>

Thirdly, these political, economic and social indicators should "drive" national security policy (they comprise the beginning and end of any war or contingency) since they override the military factors, which tend to be the blunt tool of a national response mechanism. If not, Defence could find itself planning for the wrong war (eg. a solely "military" war as resulted from the Casablanca Conference of January 1943) or structuring military forces to meet illusory military-only scenarios.<sup>30</sup>

28. The Defence of Australia 1987, a White Paper presented to Parliament by the Minister for Defence, the Hon. Kim C. Beazley, April 1987, Australian Government Publishing Service, Canberra, pp.24-27.

29. T.Godfrey-Smith, op.cit., p.1: "...low level contingencies have to date tended to focus on the tactics that might be employed against Australia at the expense of their possible origins, the possible motives and objectives of the potential aggressor, and the political context in which such contingencies might arise."

30. "It is...very probable that no direct military threat to the Australian mainland exists, or is ever likely to exist.... What this would seem to imply is that the very last function that the ADF should be equipped, or prepared, for is to fight a conventional campaign on Australian soil. It needs to be recognised at this stage that the concept of 'perceived threat' is in fact totally unhelpful as a foundation for a national strategy... the ADF is prepared to cope with contingencies which [it is] utterly unlikely ever to have to confront in practice...". G.St.Barclay, "New National Strategy Needed," Pacific Defence Reporter, August 1987, pp.14-17.



By not allowing for the direct and/or indirect financial ramifications of contingencies, at whatever level, upon Australia, official policy suffers from two pronounced defects:

(1) The "security and stability" of the region, noted by a succession of strategic documents, White Papers, and the Dobb Report, tends to undermine the credibility of most military-based contingencies, at least in the short-term; yet no clear non-military contingencies are considered.

(2) In the nuclear age, military activity as a means of securing national or political advantage, is unlikely to operate independently as it so clearly did in WW II. The means, or even the eventuality, of operating against these other forces eg. psychological, financial, diplomatic etc., are not however publicly discussed and not integrated into a single policy or document.

## 2. Defence Contingency

The Dobb Report pleaded for a "...clearer understanding of the levels of threat that we could credibly face". Therefore, "Contingency studies will identify strengths and weaknesses in our capabilities and lead to priorities for corrective development."<sup>31</sup> In answer to his own rhetorical plea, Dobb recommended:

...that a start might be made by determining [Defence's] ...adequacy ...to sustain military operations for periods of three months and six months in circumstances of intermittent low-level conflict in the north of the continent.<sup>32</sup>

These studies should be conducted as part of the defence planning base, in planning for conflict. They would determine the capability of the ADF to respond to military aggression to the north of Australia. History is adequate to describe a range of genetic occurrences which, in a worst-case political and However, they would not provide any indication of Australia's political, economic or diplomatic reactions to that same sequence of events. These, at the end of the day, are equally important.

## 3. Financial Aspects of a Defence Contingency

The limitation in relation to finance (that financial world

31. Dobb Report, p.40.

32. Ibid., p.100.

## CHAPTER 5 : FINANCE, FINANCIAL POLICY AND DEFENCE CONTINGENCIES

### 1. Introduction

As noted in the previous chapter, the *Dibb Report* drew a distinction between levels of conflict for analytical purposes. The primary goal of this analysis was to select the force structure most suited to meeting a hypothetical low level military contingency. Defence policy had accorded this level the most likelihood of occurrence, and hence, priority. The best force structure would also be that one best able to be expanded to meet conflicts which escalated to a higher level.

### 2. Defence Contingency

Following on from the *Dibb Report*, the *White Paper 1987* defined low level conflict as a "...campaign of low level military pressure against Australia." While the definition repeated the title without explaining it or justifying its origins, it added that it would entail the

use of military force (which could also be in the nature of harassment) of remote settlements and other targets in northern Australia, our off-shore territories and resource assets, and shipping in proximate areas....<sup>1</sup>

The purpose of the activities would be overtly political.

This highly suppositional definition of an event without precedent in Australian history is adequate to describe a range of generic occurrences which, in a worst-case political and economic scenario, might conceivably happen in the military or operational arena. This definition, however, does not address or even allude to the range of financial policies or responses which will be concurrent with the event, or indeed might already have taken place.

### 3. Financial Aspects of a Defence Contingency

The limitation in relation to finance (that financial world

<sup>1</sup> *White Paper*, p.24.

which exists independently of defence and its claim on Federal Government revenue) in the White Paper's definition of low level conflict is the absence of any recognition that such conflict could be considered dangerously high by the international financial community. Reactions to significantly increased political tensions will already be in train well before the outbreak of subsequent military incidents.

This is the case for three fundamental reasons. Firstly, a low level conflict involving military units may not be seen by nervous investors as being at the "reassuring" low end of a conflict spectrum as defined by approved defence policy. Instead, it would be more likely compared to the past quiescent political experience of an area which the Dobb Report concluded as "...one of the most stable regions in the world... [where there are] ...no traditional enmities or territorial disputes with neighbouring countries"<sup>2</sup>. The comparison might well then be made for the worst, and probably immediately.

Secondly, a low level contingency is rightly predicted to be preceded by a period of significantly increased political tensions. Such a period would witness some capital flight - not only of foreign capital (on which Australia is so dependent) but also some of domestic origin. In the event of escalation into the lowest conceivable level of military activity (as defined by Defence's own standards) in which the ADF has an actual role<sup>3</sup>, the trends will likely be viewed as the failure of conflict resolution, and the flight of capital could easily increase. Therefore, before a low level conflict had even appeared at the bottom end of the military range, governmental financial authorities could easily be dealing with a major crisis of confidence, as in the MX missile crisis of 1985, with serious political and economic consequences.

Thirdly, the reporting by the media, accredited or otherwise, of military activities against Australia would be sensational and

---

2. Dobb Report, p.174.

3. Which hence excludes several of the notional low level contingencies of the 1981 JCFAD report, such as the planned introduction of exotic diseases, threats to our nationals in overseas countries, support from overseas for terrorist groups operating in and against this country, and so on.



immediate. It is to be expected that overseas financial responses to events will be determined by the immediacy of news coverage and much less so by the official press releases which will probably not only follow the "news" by as long as a day but will only be communicated to the outside world by that same media. The danger from the Government's viewpoint is that its public posting of the sequence of events, no matter how proper or accurate, could conceivably result in being an interpretation of, or a defence of, its version of the "news". The Government might see the need to regulate (control would be a drastic step), to some extent, the dissemination of information regarding the contingency, rather than pursue a role where it is only one contributor to the cacophony of confusion which would no doubt surround events. In the present age's democratisation of the receipt of information (as opposed to its oligarchical supply), when both news and financial transfers occur around the clock and the globe, and when the electronic means are available to transfer billions of dollars across international borders in less than a day<sup>4</sup>, this delay in official confirmation of events could be critical.

The financial response to a low level conflict will also be twofold, international and national. The international perspective on Australia's predicament in a welter of political and military confusion will impact most severely on the capital account<sup>5</sup> and most publicly on the exchange rate, this second being also a consequence of the first. Australia, in its balance of payments, normally records a capital account surplus (net capital inflow into Australia, usually due to high real interest rates) which cancels out its standard current account deficit,

4. Although electronic transfer of funds is "real time", time also needs to be allowed for official approval, and signature, by the appropriate financial authorities - hence the crucial role of the Reserve Bank in the "defence" of Australia.

5. I. Potter, "Capital Inflow and Australia's Defence Commitment" (from H. Gelber, *Problems of Australian Defence*, Oxford University Press, Melbourne, 1970) put forward two aspects which relate peacetime defence policy to capital inflow: (1) the kind of international posture Australia may have to assume to ensure that capital is forthcoming from overseas; and (2) the influence of capital inflow in creating an interest on the part of the investing country in preserving the integrity of the country in which substantial investments are made. "The security of overseas investment, particularly on the scale now reached in Australia, must clearly have some important bearing in determining America's interest in Australia's defence." p.215. These investments include retained profits, direct investment (eg. mining), portfolio investment and institutional loans.

about 80% of which is caused by balance of trade figures. However, when the current account deficit exceeds the net capital inflow, which it would almost certainly do in a crisis of confidence resulting from military activity against Australia, then the consequences under a floating exchange rate regime would be a fall in the value of the Australian dollar against the Trade Weighted Index basket of currencies. The fall would have most impact when measured against the US dollar, for two reasons:

- (1) Trade with the USA, by volume and value, still comprises a large proportion of Australia's exports and imports; and
- (2) Trade, whatever the source or destination of the tradable goods, is still largely contracted in US dollars.

In a low level contingency the international financial repercussions would far outweigh the national financial response mechanisms generated by the conflict; in a situation of total or declared war the reverse would apply. The key difference is that in the former Australia is "on its own", hence the policy of relative or increased defence self-reliance ("absolute" defence self-reliance or military based "autarky" is at odds with the entire trend of current economics, ie. the movement towards an integrated global economy. In this respect, Australia will never be on its own). The characteristics of a financial crisis induced by a low level conflict might include:

- \* A focus on monetary policy and concerns eg. stemming the fairly predictable flight of capital from Australia via either political statements of reassurance or, more effectively, Reserve Bank intervention into the marketplace - to establish a "floor" to prop up the value of the \$A, thereby stabilizing it.

- \* Intense focus on the value of the \$A and its overall exchange rate value. In a crisis this focus would be almost entirely "speculative" and unrelated to the causes of the conflict or the more fundamental and long-term effects of military operations on the Australian economy; eg. the time lag of the contingency's impact on actual commodity volume exports (like wheat or coal)<sup>6</sup> could well be fairly long (in

---

6. Australia's four big export earning commodities are wheat, wool, coal and iron ore. Their very bulk are one defence against trade disruption. To make an appreciable dent in Australia's export trade (aside from the psychological effect, or the very real consequences of mining) would require the sinking of a lot of shipping - little of which would be Australian-owned - in which case the conflict would be no longer low level or



months) compared to the immediate impact on their value on the futures exchange.

\* Possible wild gyrations in the value of the \$A as speculators entered the market and the \$A rose from its position as the sixth or seventh most highly traded currency in the world to fifth or higher.

\* In the longer term, the mix of policies adopted by the government in relation to the crisis, the politico-military policy indicating control of the conflict, and the financial policy designed to both stabilize the exchange rate and calm the nervousness of the market.

It should be emphasized again that the concomitant financial crisis would precede the onset of military operations in a low level conflict and could easily dwarf those operations in overall repercussions on the economy.<sup>7</sup>

#### 4. Role of the Reserve Bank

The Reserve Bank of Australia (as the banker to the Commonwealth Government) is the key financial actor in a defence contingency, predominantly at low levels of conflict. In 1950, Lord Robbins maintained that for "small wars", money remained the central issue<sup>8</sup>. This is still the case. The legislative power of the central bank to interfere in the marketplace, or implement the Government's monetary policy, remains and is based on the Banking Act 1959. This in turn had its origins in the Banking Act 1945 which was the retrospective legislation applied to the Commonwealth Bank of Australia's emergency financial activity preceding and during the Second World War. Many of the features and responsibilities of the central bank originated in or were

---

regional.

7. On 6 June 1989, the *Australian Financial Review* gave front-page coverage to the reaction of financial markets to the domestic violence in China, "Hong Kong financial markets reel". Using language such as "financial calamity" and "sharemarket collapse", the article went on to state that "the mood of the Hong Kong market [was] decidedly negative [and], the fall would continue until an end to the China crisis was in sight...buyers were gambling on events, with normal investment criteria 'completely out the window'". A stockbroker was quoted as saying that it would "create the 'wrong message' world-wide for Hong Kong as an international financial centre". The thrust of the article confirmed the close link between political events and financial responses, the speed of the financial response, the room for speculation, rumour and hearsay in place of information, and the lack of control which the authorities could exercise in the short-term (ie. measured in days).

8. L. Robbins, *The Economic Problem in Peace and War*, Macmillan and Co. Ltd., London, 1950, p.11.



significantly developed during this total war.<sup>9</sup> Therefore, many of the functions carried out by the Commonwealth Bank during 1939-45 (for example, the mobilisation of present and future liquid assets, price control, control of savings), would be both irrelevant to low level contingency and inimical to the civil liberties of the population as a whole. But the primary function of the central bank would remain valid: "...to regulate the amount of money available to the community in such a way as to promote the ordered development of economic resources."<sup>10</sup>

In the Parliamentary debates of 1957 and 1959 leading up to the formation of the Reserve Bank of Australia as the new central bank (the Commonwealth Bank could no longer lead a double life as a central and a trading bank, ie. setting the rules for the banking players and then competing with them), defence requirements were ignored or overlooked. This is understandable given that in normal, peacetime circumstances the economics of defence activity is broadly a matter of government fiscal or public spending policy. Therefore an increase in defence activities and requirements, regardless of the cause, level (up to a point), or type of conflict, would be treated simply as an increase in government expenditure and once justified as necessary would receive no special measures of accountability. The financial crisis might arise only in terms of the method of acquiring the funds in the first place.

Treasurer Fadden, on 24 October 1957, stated that

...the central bank will always have adequate capacity to deal with the wide and sudden fluctuations<sup>11</sup> in basic monetary conditions that are apt to occur in our economy.<sup>12</sup>

9. The Commonwealth Bank served as Australia's central bank in WW 1 also, and managed all of the country's overseas financial dealings.

10. C.L.Hobbs, *Commonwealth Bank of Australia in the Second World War*, John Sands Pty. Ltd., Sydney, 1947, p.5. One finds no reference to the 1939 War Book in this volume; the strictures set out in that planning document (Chapter XVII) would appear to have had little impact on the financial authorities responsible for managing the country's financial and trading policies even in that simpler age. This could be so by a simple glance at the preface of contents; references to economic warfare, trade, finance and credit are beguilingly simplistic and of little avail to the policy-maker faced with the complexities of the financial world.

11. For our purposes this could include financial requirements arising from defence activity for handling a low level contingency; however, the focus of the debate revolved around bread-and-butter issues such as housing and employment; the memory of the Great Depression loomed much larger than that of WW 11.

12. *Commonwealth Parliamentary Debates*, Vol.17 (H.of R.), p. 1765, 24 October 1957.

The Reserve Bank was given responsibility for:

- (1) Effective control of credit (governs interest rates throughout the economy);
- (2) Centralised cash reserves (including Statutory Reserve Deposits, the compulsory savings of private trading banks with the Reserve Bank);
- (3) Financial stability.

These three functional responsibilities contribute to an understanding of the four basic activities that the Reserve Bank could carry out during a defence contingency:

- (1) Reassurance of investors, domestic as well as foreign. This could be achieved by public statements of confidence or the more tangible raising of interest rates on Australian Government Securities above the level the market would be prepared or allowed to offer (control of credit).
- (2) Open-market operations (ie. the buying and/or selling of currencies by the Reserve Bank) to maintain exchange rate stability of the \$A. This would facilitate for example the continued smooth operation of contracts negotiations involving exports and imports.
- (3) Sale of Treasury bills to the public, or direct lending to the Government to finance the cost of military operations - results in an increase in the Public Sector Borrowing Requirement (PSBR), or an increase in the public's debt to itself in the future.
- (4) Use of the Statutory Reserve Deposits, or even an increase in their ratio of about 5% of total private bank liquid assets, to fund short-term financial necessities associated with the defence contingency (these reserves were estimated at some \$3.6b. in 1988).<sup>13</sup>

The role of the Reserve Bank would be vital to the financial control and management of monetary policy during a low level conflict especially if it co-incided with the Government's attempt to avoid making alterations to its fiscal policies. The latter would be a clear signal to financial markets and investors that the conflict might be more serious and/or no longer as low level as the government was trying to maintain. The Reserve Bank still controls credit and centralized cash

13. The details of this centrally pooled reserve were changed at the time of the 1988-89 Budget (see the Treasurer's speech of 23 August 1988) but the power of the Reserve Bank to co-opt this "cash" remains.



reserves; however, the 1983-84 Annual Report<sup>14</sup> noted that "...the concurrent removal of most exchange controls [effective on 12 December 1983] reduced official influence in foreign exchange transactions...".<sup>15</sup>

The Reserve Bank still has an explicit legal right to manage Australia's exchange rate if required and retains a supervisory role requiring private banks to consult it on, and to operate within, prudential matters (ie. central bank policy worked out in close consultation with the Government) determined by the Bank. Thus, in this case, in the event of a crash of the \$A resulting from loss of investor confidence due to military conflict involving Australia<sup>16</sup>, the Reserve Bank could conceivably staunch the capital outflow within twenty-four hours. The decision to do so would, of course, be subject to other economic and political considerations. Arguments against intervention are similar to those which caution highly indebted countries from reneging on their debt repayments.

Firstly, the falling \$A would lower the value of the capital currently invested in the country, a decline which might not be counterbalanced by an attempted and commensurate rise in interest rates (to be engineered by the Reserve Bank in consultation with the Government). Therefore, those investors who did not redeem their investments at the earliest opportunity upon receipt of news of the unstable strategic environment would be tempted to leave their investments in the country rather than accept the large losses which a late withdrawal of funds might entail. The motive would not be patriotic since finance seldom recognizes abstractions beyond real rate of return; the motive would be to ride out the crisis and await the rise of the value of the \$A. This is called letting the market sort itself out, an heroic course of non-action by a government believing in the

14. Reserve Bank of Australia Annual Report 1983-84, Australian Government Publishing Service, Sydney, 1984, pp.1-2.

15. Textbook problems with variable exchange rates include: (1) sacrifice of convenience from not having the same unit of monetary account; (2) added uncertainty for traders of exported/imported goods; (3) speculative movement of short-term capital which can destabilize the currency.

16. A fall in the value of the \$A has two very immediate effects: (1) Australia's foreign debt - denoted mainly in \$US - rises sharply; and (2) Australia's power to purchase overseas equipment (eg. replacement military hardware) declines sharply.



"invisible hand" of Adam Smith.

Secondly, overt intervention in the marketplace by legal means, such as rescinding the rights of currency dealers to trade, might be interpreted by investors as a loss of control by the government in the face of the crisis; this loss of control could be military or political. It would be far better that the Reserve Bank intervene on behalf of the \$A, buying them discretely through normal open-market operations. It could even engage its overseas counterparts, like the Federal Reserve Bank of America, to also buy \$As (the financial equivalent of invoking the ANZUS Treaty).

Thirdly, if the Reserve Bank were to intervene in the market, then it could discourage future investors from entering the Australian market, either from the stock exchange or from buying Australian Government bonds or securities (the money market). Since Australia depends heavily on capital inflow then the powers of the Reserve Bank to intervene in the market in a low level contingency would be used neither lightly nor immediately. Much would depend on the movements of the \$A.

Against these arguments is the telling argument that the government might be dealing effectively with the defence of the country, particularly if some casualties had been sustained. However, in a low level contingency there are certain limitations to the efficacy of military action as a tool for resolving the problem:

- \* The government is tasked to provide for the national security of the country, which transcends the narrow military functions of countering the obvious and transparent movements of the "enemy" over a geographical environment. It also has to defend the institutional and national interests of the country (which includes the \$A).

- \* Despite the caution and imprecision attached to definitions of low level contingency in approved defence policy, nevertheless it is clearly recognized that its central feature is its marginality to the overall well-being of the country. It can become central at this stage only in the psychological sense or the political sense (the Australian Government may make it central by virtue of its reaction or over-reaction).

\* Escalation of a low level contingency is not inevitable either in scale or over time. Therefore the role of the military would be confined to cautious activity perhaps surpassed by the feverish activity occurring in economic and diplomatic circles.

In financial terms, the Government would probably find that its best overall financial policy might be monetary<sup>17</sup>, for defending the position of the economy, and sufficient fiscal adjustments to accommodate the increased military requirements for containing the level of the contingency (these would of themselves probably be so small - in the region of tens of millions of \$As initially - that they could be absorbed through the normal administrative channels). Monetary policy in this sense means varying the quantity of money in circulation or altering the cost of credit. The means of doing so are twofold: firstly, discount policy (changes in central bank's lending rate) and open-market operations (buying/selling government notes to increase/decrease the amount of money in circulation). They could also create a credit squeeze by capping the amount of available for loans; the purpose of this restrictive monetary policy would be to balance the government's own plans for increased spending on defence related items. If not undertaken, it could easily lead to a sudden and significant expansion in the money supply and, very quickly, inflation.

## 5. Escalated Low Level Contingency

A low level conflict could become more violent and serious (depth), remain at the same level but become more widespread (breadth) or linger over a protracted period of time with or without one or other of the two developments above. In this last case, escalation could depend also on the reactions of the Australian Government as pressures by the political processes to "do something" about the crisis increased. This escalated low level conflict<sup>18</sup> with "...the attacker supplementing or

17. The advantages with monetary policy in a low level contingency are that it can be quick, informal and does not require legislation. Therefore, at this stage, fiscal policy must suffer the reverse, ie. it is slow, formal, annual and requires the involvement of the Parliament.

18. When this stage of contingency definition was labelled as "medium" it could still be maintained for force structure purposes that the contingency could be entered into at this level. However, the White Paper 1987



substituting unconventional tactics and forces with military units prepared to confront our forces direct..."<sup>19</sup> would probably involve enlargement of a volunteer army and an acceleration of munitions replacement and production. At this escalated stage, as a conflict became much more serious, the financial focus would adjust with it. Monetary policy (eg. increased interest rates on Australian Government Securities) would still have to be closely monitored and managed. Additionally, the fiscal theory of war control would now likely come into play - how the state is to pay for the burgeoning conflict. The choice of financial policy in an escalating conflict would be complicated by the investment community's assessment of it as "on-going", given its measure of time is in days and sometimes hours, as opposed to the indefinite timescale alluded to in defence policy.

In low level conflict the Reserve Bank of Australia would be the prime actor in handling day-to-day monetary policy and maintaining Australia's financial credibility, via open-market operations, in the international arena. The prime task would be to maintain the stability of Australia's currency. As the conflict endured and/or escalated up the hypothetical contingency spectrum, the primacy of this task would be replaced by the equally important one of coping with the financial demands of the crisis. These demands would not yet be strains; if a crisis were to peter out after some six months (the limit set by Dibb for initial military studies) the extra operational, fuel and maintenance costs could be absorbed through normal supplementation within existing administrative machinery and processes.

However, for an unresolved crisis which both escalated and endured, the executive of the government would have to seek means to pay for this unbudgeted expense. In Robbins' "small wars", money remains the central issue - as it often is in

---

marked a signal shift in policy debate; a medium level contingency was only an escalation of a low level one and logically could only proceed from one. Therefore, a low level contingency had to happen first, whatever the consequent course of the conflict.

19. White Paper 1987, pp.24-25.



peacetime. By adopting a policy of "business as usual",<sup>20</sup> the government would be seeking to downplay its concern. It would seek at this stage to keep overall monetary, fiscal and defence policy both under control and co-ordinated. It would be folly to interfere with the entire basis of production and distribution in the economy solely to resolve a conflict which, even at this stage, would likely have had very limited impact on the totality of Australian society. Assuming a successful stabilization of the currency by the Reserve Bank, the fiscal options<sup>21</sup> available to the Government would include the following:

- \* Internal reallocation of Federal Government expenditure from non-defence functions to defence;

- \* Borrowing from the public (deficit consequences - but non-inflationary because it absorbs purchasing power from the public, which otherwise might have been spent on consumer goods);

- \* Borrowing from the Reserve Bank (deficit and inflationary consequences - consists mainly in the printing of currency and a rise in the base money supply);

- \* Increased taxation;

- \* Borrowing from overseas; and

- \* A combination of the above.

The first is feasible in the long-term only, because of heavy government contractual obligations for social programs, debt recovery and wages/salaries etc., entered into years ahead of the event in question. There are also legal problems associated with transferring monies from one appropriation to another within any one budget year, and such action could contradict the government's own policy of playing down the conflict for the sake of investor confidence.

Increased taxation at this stage of the conflict, escalated low

20. This phrase was coined by the British Government in August 1914. It began as a conscious policy but was reduced to a slogan by December 1916 when Lloyd George became Prime Minister. Its validity suffered severely as a result of literal business as usual with the munitions scandal of 1915 and the excess war profits made by manufacturers throughout that war.

21. Fiscal policy is broadly the government's own spending, which divides into expenditure and revenue (in a normal budget year). The resulting sub-problem is when expenditure exceeds revenue which it would almost certainly do in the event of conflict. The three functions of fiscal policy are : (1) regulate the level of economic activity, the price level and the balance of payments; (2) allocate resources between the public and private sectors; and (3) influence the distribution of income and wealth via taxation and social spending.

level contingency, which defence policy maintains the ADF should be able to counter essentially from the force-in-being<sup>22</sup>, would not be feasible either. Taxation is unpopular at the best of times; increased taxation more so. Taxation is also central to the life of civilized society whereas the defining characteristics of an escalated low level contingency keep it peripheral to the essential functions, as opposed to the political outlook, of society. To raise new taxes would be quite simple administratively but divisive, and an admission of the seriousness of the conflict from the government's viewpoint.

The most probable solution to the government's need for immediate and sizeable additional funds for increased military operations would be to borrow, either from the Reserve Bank (which prints the money and gives it to the government to spend/meet its bills as they fall due), or from the public (the Reserve Bank sells Treasury bonds to the public and forwards the proceeds to the government). In either case the deficit is increased. Adam Smith is reported to have said that there is plenty of ruin in a nation, meaning that, if necessary, a nation can afford to impoverish itself to ensure its own survival, its impoverished survival being its legacy to posterity. But in the case of an escalated low level contingency the margin of conflict does not encroach on the existence of the nation *per se*. Therefore, the financial responses should be discrete, effective and indiscriminate in the sharing of the sacrifice. Borrowing is the best means to accomplish this end, at least in the short-term.

Because escalation, as defined here, assumes the form of a limited war ("military units prepared to confront our forces direct") but falls short of extremes involving the "ruin of a nation"<sup>23</sup>, the level of additional tolerable debt raised to

22. White Paper 1987, p.25.

23. Dr.H.Kissinger defined limited war as one "...fought for specific political objectives which, by their very existence, tend to establish a relationship between the force employed and the goal to be attained. It reflects an attempt to affect the opponent's will, not to crush it, to make the conditions to be imposed seem more attractive than continued resistance, to strive for specific goals and not for complete annihilation." from H.A. Kissinger, *Nuclear Weapons and Foreign Policy*, Harper for Council on Foreign Relations, New York, 1957, p.108.

sustain its conduct would depend on such economic factors as the current level of overseas debt<sup>24</sup>, the Federal Government's portion of the public sector borrowing requirement (PSBR) at that time, management of the exchange rate and possibly and most importantly, a foreseeable end to the conflict. A protracted low level conflict or one that threatened to burst out unexpectedly or randomly, even for quite short periods of time, has the potential to cause a haemorrhaging of Australia's financial position.

## 6. Role of the Treasury

The functions of the Treasury are normally devoted to the presentation of the annual budget (and recently the April/May Economic statements) and economic analysis of the trends in the Australian economy. In the event of a defence contingency it would continue to advise the government by advocating those economic policies best suited to the prevailing politico-military situation.

In the event of a contingency of any sort, Treasury would expect the following to occur but not necessarily in this order<sup>25</sup>:

- \* The \$A and investment would fall almost immediately;
- \* This very fast market reaction would be tempered by the public utterances of Australia's key investors and trading partners, especially the USA and Japan;
- \* Perceptions of the course of the contingency would depend heavily on strong political leadership; both media and financial interests would respond to this leadership;
- \* Leadership would be taken over by a "war cabinet" which would determine overall national security policy (as adopted in the UK during the Falklands conflict);

24. Gross foreign or external debt was reported in *The Australian* of 25 November 1988 as being \$A115.1b. This was comprised of: (1) Federal Government - \$22.9b.; (2) State Governments - \$8.5b.; (3) Public sector - \$22.4b.; (4) Private sector - \$61.3b. On 6 February 1989, Argentina's foreign debt was reported in *Time Magazine* as \$US57b. This simple comparison ignores several other factors taken into account by bankers: Australia's overseas assets amounted to some \$25-30b., whereas Argentina's were minuscule at only some \$2b. In Argentina, the government was largely responsible for the entire debt; in Australia, the Federal Government was responsible for some 20%. Australia has always been considered a safe haven for investment (which would be reconsidered in the light of any contingency) as opposed to Argentina which must glean loans from the IMF.

25. The following is based on an interview, on 9 December 1988, with Mr. D. Moore, ex-Deputy Secretary of the Treasury and now with the Australian Institute of Public Affairs.



\* Borrowing from overseas for the contingency would in fact be done in the name of funding general expenditure; lending is not normally provided specifically for underwriting wars, unless the vested interests of the lender were clearly involved - which would be unlikely in a contingency;

\* Despite the financial policies pursued by the government, great stock would be placed on the ability of the ADF to control, if not resolve, the contingency.

The advice of Treasury would be advocated most strongly in a "war cabinet"; it would be a third source of economic advice, along with the Department of Finance (fiscal policy) and the Reserve Bank (monetary policy). The role of the Treasury would also be to co-ordinate, or mediate between, these respective policies.

## 7. More Substantial Conflict

The Dobb Report's definition of more substantial conflict<sup>26</sup> requires "...defined military objectives ...specific targets of military value... and... intense conflict of limited duration...". As with the *White Paper 1987*, invasion is ruled out, but limited lodgement or major assault is entertained as a distinct possibility at this level. Parenthetically, it is not specified why this course of action is embarked upon: possibly the ADF has contained the aggressor at a lower level of conflict and now the enemy must escalate, perhaps through desperation. Possibly the enemy has succeeded at a lower level and is now capitalising on that success. The features which differentiate this level from lower levels are, firstly, the focus of conflict is moved from the sea/air gap to continental Australia, and secondly, regular ground troops are involved. But as yet there is not a state of declared war and certainly no attempt at subjugation.

The movement from escalated low level contingency to more substantial conflict entails a quantum leap from

---

26. Dobb Report, p.54.

"confrontation"<sup>27</sup> into an outright limited war scenario. Because of the generalised nature of these horizontal levels of conflict, it is difficult to predict the financial responses of the government. "More substantial conflict" (still short of declared war) implies a very serious military situation but one still largely confined to the northern fringes of the continent and not directly and physically affecting Australian society as a whole, as opposed to its interests. However, it would be a deeply traumatic group experience and would rattle the expectations of the future well-being of most Australians (Keynes' "animal spirits" on which patterns of future investment were largely based). The scenario implies that no favourable outcome or short-term political settlement is in sight.

The government would have two ways of handling such a turn of events:

- \* By remaining a liberal society engaged in a limited war (as advocated by Keynes and adopted by the USA in Vietnam);

- \* By reversion to war-time direct controls (as happened in World War 11, and subsequently supported by Robbins).

The financial and social differences between these opposing policies are: in the first, the price system and the mechanism of the market remain central to the continued system of distribution in society (see "Keynes", Chapter 1); in the second, this system is suspended and replaced by such centrally controlled features as rationing and price fixing (see "Robbins", Chapter 1). This latter approach has some of the elements of mobilisation, where the central authority controls the workings of supply and demand to channel production into selective areas useful to defence. A by-product is that a successful, short-term brake is put on inflation, the "bete noir" of most governments.

---

27. J.A.G.Mackie drew six lessons or defining characteristics from the "Confrontation" episode: (1) The guerilla forces were very small in numbers but tied down large numbers of regular defenders; (2) military pressure served as background "noise" to the up-front high profile political and diplomatic negotiations; (3) seizure of territory was not the issue; (4) guerilla troops were slowly replaced by regular troops; (5) surprise, improvisation and unorthodox tactics were the norm; (6) overt violence was avoided eg. assassination. See, J.A.G.Mackie, *Low Level Military Incursions: Lessons of the Indonesian-Malaysia "Confrontation" Episode, 1963-66*, Working Paper No.105, Strategic and Defence Studies Centre, ANU, Canberra, 1986, pp.24-25.



As an escalated conflict developed symptoms of a more substantial one, such as limited lodgement, mining of ports, direct conventional military force confrontation etc., then the government might be compelled to levy a form of war taxation, in the context of two issues. Firstly, it could be presumed that "...strike and other offensive measures against the adversary's military bases and infrastructure..." had either failed or not been countenanced<sup>28</sup>. Secondly, the additional taxation would probably serve the expansion base rather than the incremental costs attached to the extra activity of the regular ADF. The two options set out in the previous paragraph illustrate the importance of financial policy, not only to the successful conduct of a military crisis (which may have produced the particular "wartime" financial policy in the first place), but to the state of the economy as a whole. As a more substantial conflict (as set out in the *White Paper 1987*) began to adopt the features of a major military venture against Australia, then the government would be compelled to introduce (and justify the introduction with an appropriate description like "Defence Contingency Tax") some form of temporary additional taxation if, and only if:

- \* in the assessment of the Treasury, loans raised with or via the Reserve Bank were inadequate to cover the costs of the emergency;
- \* military advice could not foresee a military solution or conclusion to the conflict on terms which appeared to favour Australia;
- \* Australian foreign intelligence services indicated that there was little or no likelihood of allied or other international intervention to resolve the conflict to suit Australian national interests;
- \* with the raising of loans to date, along with a probable substantial balance of payments deficit, the Reserve Bank were to advise that investor confidence in the Australian economy had begun to slump, resulting in adverse effects on the exchange rate;
- \* economic indicators began to show an increase in

28. The retention of offensive strike assets in the ADF order of battle implies a belief that the future contingency could be resolved quickly, victoriously and almost without cost if only the political masters would be as bold; this, despite the obvious lessons of Vietnam. War taxation is the admission of a long-term, serious conflict. The military forces during the Vietnam era were expanded without recourse to other financial policies.



inflation, and/or strains, or adverse trends in the economy - general economic trends seen by everyone.

Even more substantial conflict is only a limited war although of the most serious kind.

In limited war, nations do not bring all of their power to bear, so that their productive volume is not decisive. What is important economically is the rapidity with which the economy can adjust to the new demands arising out of the specific situation of the limited war.<sup>29</sup>

Financial policy remains the means by which the range of defence conflicts are managed in economic terms up to the highest level, including the outbreak of declared war. Keynes had argued this, and stated that it should remain paramount and central to war organisation even in a situation of total war. However, Robbins added from experience that once the threshold of taxation and borrowing for war purposes is breached, the existing financial policy options are exhausted. They become subsumed in a policy of national mobilisation.

## 8. Mobilisation

Current defence policy considers mobilisation to be implausible and thus an inappropriate basis for defence planning. Mobilisation, understood in traditional terms, would be a quantum leap above the requirements of even the highest pitched defence scenario which is currently hypothesized<sup>30</sup>. The White Paper 1987 did not consider a state of declared conventional war involving Australia to be a feasible option outside the scenario of global nuclear war. Only at this level would mobilisation of Australia's resources, as opposed to force expansion, be relevant. Nevertheless, the concept cannot be dismissed totally because, as has been pointed out "...the strains on the economy implicit in limited war, are not negligible."<sup>31</sup> If the concept of mobilisation was therefore changed from one of numerical

29. J.R.Schlesinger, *The Political Economy of National Security*, Stevens and Sons Ltd., London, 1960, p.72.

30. "...it would seem reasonable to assume that [low level contingency] would not require resources initially beyond those already contained within Australia's regular forces...", G.L.Cheeseman, "Army Force Development", in D.Ball and J.O.Langtry (eds.), *Problems of Mobilisation in Defence of Australia*, Canberra, Phoenix Defence Publications, 1980, p.29. It is interesting to note that the financial considerations surrounding mobilisation are totally ignored.

31. *Ibid.*, p.74.

increase to one of qualitative adjustment of the institutions and mechanisms of society and the economy (with some increase in production), then its relevance to modern, limited war would be re-established. The White Paper committed itself to a wartime administration plan only, involving force expansion (an inherent military concept), war reserves and stockholding<sup>32</sup>. These particular tasks do not of themselves require special financial considerations (ie. policy sea-changes of a fundamental kind) beyond mere increases in spending.

Even in contingencies pitched at the highest level, mobilisation of capital would not occur. Instead, finance would be raised in a similar manner to its peacetime equivalent, except with a possibly heightened sense of urgency and higher interest rates. J.Schlesinger, later a US Secretary for Defence, divided the economic responses of the US Government to hypothetical threat into three phases or levels:

- (1) Retention of free market principles, for the duration of the conflict, as in peacetime:
  - (a) increased preparedness - balanced budget, special taxes (normality);
  - (b) limited war - mildly unbalanced budget as increased spending outpaced revenue raising (defence economy);
  - (c) total war<sup>33</sup> - serious budgetary disequilibrium and considerable additions to the deficit as (b) above is exacerbated (war economy);
- (2) Institution of price & monetary controls:
  - (a) increased preparedness - no direct controls (ie. these would not be instituted at such an early stage), so (1a) would apply (normality);
  - (b) limited war - voluntary controls leading to selectively imposed controls eg. wage/price freezes or fixing (defence economy);
  - (c) total war - general price controls and credit rationing, interest rate fixing (war economy);
- (3) Allocation of supply:
  - (a) increased preparedness - market mechanism applies (ie. as for (2a) above) - (normality);
  - (b) limited war - voluntary controls (formal or

32. White Paper 1987, Chapters 2 and 6 principally; this is aside from other instruments of policy such as "industry involvement".

33. Schlesinger includes nuclear war in this category but it is difficult to envisage the same economic and financial responses to it, given the speed with which it would be conducted and the level of destruction which would be visited on the country's economic base. Still, it was written in 1959 when the "unthinkable" was thought about with serious quantifiable logic and rationality.

informal), including consumer rationing, and would probably include the government setting some priorities in resource allocation (defence economy);  
 (c) total war - general allocations set by the government, requisitioning, personnel direction (total war).

While Schlesinger's comments are not specifically devoted to finance, it is clear from the above that finance is more central to the lower levels of hypothetical conflict than at higher levels, when the role of war finance slides into a solely supportive role for the war economy (this point had already been made by Robbins). Schlesinger describes this adjustment as mobilisation. "The reorientation of the economy that is required may be so severe that the price system becomes an inadequate instrument to achieve the necessary production shifts, and it may be necessary to utilize a supplementary system of controls to achieve the desired transformation."<sup>34</sup> However, mobilisation is not considered inevitable.

The point of discussing mobilisation here, even though not countenanced by either experience or defence policy, is to indicate the features which differentiate it from other lower contingency levels, at least from the financial point of view, and to highlight the seriousness of a situation in which mobilisation, as an option, could be entertained.

## 9. Role of Defence and Government

The role of the Defence Department in the various levels of contingency would concentrate on two aspects: the conduct of operations, and the procurement of supplies, spare parts and replacement or additional equipment. Both tasks would require substantial and on-going justification to the several groups of decision-makers involved. Defence's contribution to financial policy-making would be meagre. It would perform a role limited to resource consumption. The request for resources, which would in no small way set the financial policies to be adopted, would depend on the actual conduct of the contingency and here

<sup>34</sup>. Schlesinger, *op.cit.*, p.74.



military advice would weigh heavily.

Section 7 of the Defence Act 1903 specifically precludes financial provisions. The Audit Act 1901 is the basis for the expenditure power and authority of the Commonwealth Government; financial policy both stems from and is legally bound by the provisions of this act. Since the Audit Act is the responsibility of the Department of Finance, that department would be the first tier of government to oversight the impact of any defence contingency on the public's fiscal purse. The Reserve Bank would be responsible for the government's monetary policies. The Department of the Treasury might only become involved at a later and more serious stage, and then to provide co-ordination and advice of a fiscal nature (eg. whether to borrow, tax, cut other non-defence spending etc.). Appeals to ANZUS would be the responsibility of the Department of Foreign Affairs and Trade. Oversighting all, probably for each and every level of contingency, would be an ad hoc committee of the Cabinet (Prime Minister and Cabinet).

#### 10. An Indication of Costs

Financial policy in the variously conceived levels of defence contingency would not change solely as a consequence of the abstract and orderly notions of financial policies and options set out in this thesis. The response would include these, but would likely be driven also by an instinctive awareness of the most rational course of action possible under the circumstances, ie., that at a certain intensity of military conflict, or at the breaching of a tolerable cost limit, or under pressure of public opinion, the government would be forced to "do something". Under these circumstances, monetary policy, for example, may not necessarily always be the principal instrument of the financial policy adopted.

Implementation of new, or alteration of existing, financial policy would likely be based on two fundamental premises:

- (1) The immediate financial costs, based on the level of conflict and resulting defence requirements, and the

response of the markets;

(2) The expected financial costs, based on the anticipated duration, scale and outcome of the conflict.

Both these premises would be heavily dependent on Defence advice. Decisions to change current financial policy would rely to a certain extent on extrapolations of likely spending patterns.

To set an order of magnitude on the possible direct costs of conflict levels to the Australian community, the following sets out an ascending scale of indicative military costs:

\* **Peacetime** - Australia currently spends about \$US16m. per day on the administration, maintenance and operation of its defence forces (based on \$US1-0.80c Australian).

\* **Exercises** - Kangaroo 89 can be costed at some \$US2.7m. per day, although this excludes the cost of live ammunition. It could not be considered additional to normal peacetime expenditure and is included for indicative purposes only. If it were additional it would be only some 2-3% above normal expenditure.

\* **Low level** - Australian expenditure on defence averaged about 3% of GNP/GDP from 1953-54 to 1986-87 (therefore excluding the Korean War); peak expenditure in 1967-68 during Vietnam reached 4.4% of GDP or 44% above its average experience in the nuclear age. No special financial provisions were introduced to take account of this increased expenditure; in other words, if defence spending jumped to \$US23m. per day to handle a contingency, this, of itself, would not be enough to induce authorities to alter peacetime economic policy.

\* **Escalated low level** - at its height in 1968, the USA was spending some \$US50-60m. per day on the war (current \$) or about 25% above its normally high peacetime rate of defence expenditure. This was largely covered by borrowed money, rather than additional taxes, to allay the unpopularity of the war.

\* **Limited war** - the UK spent about \$US28m. per day on the Falkland Islands war, all of which was covered through normal administrative accounting mechanisms.

\* **More substantial conflict** - Iraq/Iran spent in the region of \$US100-135m. per day on regular hostilities involving large scale conventional operations by military forces. These countries had to resort to borrowing, austerity measures and modifications to their original financial, defence and domestic policies to sustain the conflict.

The Dibb Report recommended the study of the adequacy of existing stocks of materiel to sustain military operations for periods of three and six months, in circumstances of intermittent low level conflict to the north of the continent. In the context of the above, Australia could expect to spend several hundreds of millions of dollars over this time frame, over and above normal defence function expenditure, and would need to do so without upsetting the overall economic policies of the government.

In short, the financial policy ultimately adopted will depend firstly, on the provision of advice regarding the choice of monetary or fiscal policies and their utility in relation to containing economic pressures arising from the military situation, and secondly, on some combination of the financial costs outlined above, multiplied by the expected duration of operations.

## 11. Conclusion

While the future is unknown and subject to chance, for institutional purposes, it remains reasonably predictable, and planning must proceed on that basis. Finance and defence policies, as instruments of government, should likewise proceed from a basis of reasonable predictability, and contingencies should be credible exercises in testing their efficacy. Financial policy is exercised, judged and refined daily as a matter of course. Defence policy is not.



## CONCLUSION

Financial policy is one of the key common denominators (and certainly not the least important) underpinning the defence of Australia against aggression and other less defined hostile activities. But it is not a constant variable and cannot be presumed.

The priority given to financial policy during the conduct of conflict would depend on the government's perception of all facets of the national interest, its military and economic dimensions figuring particularly. Military security and economic well-being are both central dimensions of the national interest, but the relationship between the two, the hierarchy of significance at any given point, and the nature and degree of the trade-offs required between them, are not fixed or clear cut. Nor, as noted earlier, is the fiscal or monetary response to a particular military contingency decreed in policy. Quite the opposite. Almost no attention has been given to developing a financial policy to deal with different levels or kinds of threat; nor has Defence adequately incorporated, or been expected to incorporate, the financial dimension into contingency planning. Its policy remains one of military-oriented defence rather than broad-based national security.

Some general comments can, nonetheless, be made about the financial dimension of contingencies. It should be crucial for the financial, defence and security communities to explore the policy implications in this area.

In the context of a low level contingency the fiscal theory of war control will prevail. At some level higher than this (much higher since this second approach is based on the experience of the democracies leading into total war), this theory will break down and will be replaced by state intervention or even control.

The fiscal theory of war control sees "...the essential problem

as one of public finance."<sup>1</sup> This includes taxation and non-inflationary borrowing on the part of the government. The purchasing power of consumers should be reduced (to control demand), the stimulus of profit should be the overriding incentive for the private sector to contribute to the national security policies of the government (by maintaining supply), and the primacy of the price mechanism might then be assured of performing its allocatory functions. This policy is suitable for the conduct of "small wars" by a liberal democracy. In short

... a courageous use of the tax instrument [is] the main desideratum of economic policy...[and there is] no need to transform the whole basis of production and distribution in order to muster resources....<sup>2</sup>

The market and the price mechanism remain central to the economy.

A defence contingency greater than this might create demands for personnel and finance, generate scarcities, and prompt a loss of business/investor confidence which would cause this policy to break down. Some of the symptoms of this policy disintegration might include the necessities of immediate supply, abnormal conditions of risk (affecting investment by business, which will not know the duration of the conflict, and the physical security of assets, where destruction by an enemy is a possibility), the unreliability of the market price as an allocative mechanism when government credit is unlimited and, as a consequence, the institution of a policy of price fixing. In short, the market and the price mechanism are suspended.

The origins and definition of low level conflict lie between these two extremes of governmental economic and financial response, between peace and war (or more substantial conflict). Whether it is closer to peacetime experience, and hence a discrete, market oriented financial response can be conducted, or whether it is likely to develop the characteristics of a war, and hence the necessity for state control is paramount, only time, the circumstances of the contingency and the policies of the government, can determine.

1. L. Robbins, *The Economic Problem in Peace and War*, London, Macmillan and Co. Ltd., 1950, p.31.

2. *Ibid.*, p.33.

Again, financial policy is not a constant variable and cannot be presumed. A national defence strategy is sought on the basis of the enduring fundamentals of the country's geographic environment; but the financial underpinnings of such a strategy continue to evolve at a dizzying pace (technologically, eg. the introduction of computers to transfer investment funds around the globe in near real time, or policy-wise, eg. the changed rules governing Statutory Reserve Deposits in the context of the 1988-89 Federal Budget).

Financial policy is subject to several major influences and constraints, of which defence policy is but one. The principal influences on financial policy, even during significant military conflict, are likely to remain largely economic and political. Clausewitz is famous for his description of the "fog of war" in relation to military operations. This thesis argues that financial policy is equally subject to strains, to institutional pressures and to lack of reliable information for rational decision-making. It argues also that in most cases it is as important a component of the effective management of war or conflict as is defence policy.

An understanding of the legal complexities of low level military threat has been recently pleaded for.<sup>3</sup> This paper argues that the economic complexities and financial implications should also be recognised.

Deacon, T. and Fogarty, J., *Australia and Argentina: on parallel paths*, Melbourne University Press, Melbourne, 1984.

Endslevoh, A.C. and Smith, K.W., *How Much is Enough?*, Harper and Row, New York, 1971.

Geoffrey-Smith, T., *Low Level Conflict Contingencies and Australian Defence Policy*, Canberra Papers on Strategy and Defence No. 34, Strategic and Defence Studies Centre, ANU, Canberra, 1985.

Gale, M., *The Australian Military Response to the Fiji Coup: An Assessment*, Working Paper No. 171, Strategic and Defence Studies Centre, ANU, Canberra, 1988.

3. A. Bergin, "Legal Complexities in Low Level Threats", *Pacific Defence Reporter*, Peter Isaacson Publications, Melbourne, April 1988, pp.16-17.



## BIBLIOGRAPHY

- Alnasraivi, A., "Economic Consequences of the Iran-Iraq War", *Third World Quarterly*, 1986.
- Asteris, M., "British Overseas Military Expenditure and the Balance of Payments", pp. 194-214, from Bateman, M. and Riley, R.(eds), *The Geography of Defence*, Croom Helm, London, 1987.
- Babbage, R., *Managing Australia's Contingency Spectrum for Defence Planning*, Working Paper No.108, Strategic and Defence Studies Centre, ANU, Canberra, 1986.
- Babbage, R., *Rethinking Australia's Defence*, Queensland University Press, St.Lucia, 1980.
- Ball, D., *The Politics of Defence Decision Making in Australia: The Strategic Background*, Reference Paper No.93, Strategic and Defence Studies Centre, ANU, Canberra, 1979.
- Barret, R.J., *The Economy of Death*, Atheneum, New York, 1973.
- Blainey, G., *The Causes of War*, Sun Books, Melbourne, 1977.
- Butlin, S.J., *War Economy, 1939-42*, Halstead Press, Sydney, 1961.
- Cheeseman, G.L., "Army Force Development", in Ball, D. and Langtry, J.O.(eds), *Problems of Mobilisation in Defence of Australia*, Phoenix Defence Publications, Canberra, 1980.
- Clayton, J.L., "Vietnam: The 200-Year Mortgage", *The Nation*, 1969.
- Clotfelter, J., *The Military in American Politics*, Harper and Row, New York, 1973.
- Defence of Australia 1987*, a White Paper presented to the Parliament by the Minister for Defence, the Honourable Kim C. Beazley, MP, March 1987, Australian Government Publishing Service, Canberra, 1987.
- Duncan, T. and Fogarty, J., *Australia and Argentina: on parallel paths*, Melbourne University Press, Melbourne, 1984.
- Enthoven, A.C. and Smith, K.W., *How Much Is Enough?*, Harper and Row, New York, 1971.
- Godfrey-Smith, T., *Low Level Conflict Contingencies and Australian Defence Policy*, Canberra Papers on Strategy and Defence No.34, Strategic and Defence Studies Centre, ANU, Canberra, 1985.
- Gubb, M., *The Australian Military Response to the Fiji Coup: An Assessment*, Working Paper No.171, Strategic and Defence Studies Centre, ANU, Canberra, 1988.

- Higgott, R.A., *The World Economic Order and Australia: Towards a Wider Definition of Security*, from the conference on Australia and the World, Prologue and Prospects, Australian National University, Canberra, 6-9 December 1988.
- Kennedy, G., *Defense Economics*, Duckworth and Co. Ltd., London, 1983.
- Keynes, J.M., *The General Theory of Employment, Interest and Money*, Papermac 12, Macmillan and Co. Ltd., London, 1964.
- Keynes, J.M., *How to Pay for the War*, Macmillan and Co. Ltd., London, 1940.
- King, R., "The Iran-Iraq War: The Political Implications", Adelphi Paper No. 219, International Institute for Strategic Studies, London, 1987.
- Korner, P., *The IMF and the Debt Crisis*, Zed Books, London, 1986.
- Long, G., *The Six Years War*, the Australian War Memorial and the Australian Government Publishing Service, Sydney, 1973.
- Macaulay, T.B., *The History of England*, edited and abridged by H. Trevor-Roper, Penguin English Library, Harmondsworth, 1979.
- Mackie, J.A.G., *Low-level Military Incursions: Lessons of the Indonesian-Malaysia "Confrontation" Episode, 1963-66*, Working Paper No.105, Strategic and Defence Studies Centre, ANU, Canberra, 1986.
- McLachlan, K. and Joffe, G., *The Gulf War: A Summary of the Political Issues and Economic Consequences*, Economist Intelligence Unit, London, 1985.
- Mobbs, C.L., *Commonwealth Bank of Australia in the Second World War*, John Sands Pty.Ltd., Sydney, 1947.
- Potter, I., "Capital Inflow and Australia's Defence Commitment", pp.205-221, from Gelber, H.G.(ed), *Problems of Australian Defence*, Oxford University Press, Melbourne, 1970.
- Proxmire, W., *Uncle Sam: The Last of the Bigtime Spenders*, Simon and Schuster, New York, 1972.
- Review of Australia's Defence Capabilities*, Report to the Minister for Defence by Mr Paul Dibb, Australian Government Publishing Service, Canberra, 1986.
- Robbins, L., *The Economic Problem in Peace and War*, Macmillan and Co. Ltd., London, 1950.
- Robbins, L., *Money, Trade and International Relations*, Macmillan and Co. Ltd., London, 1977.
- Schlesinger, J.R., *The Political Economy of National Security*, Stevens and Sons Ltd., London, 1960.

Scott, E., *Australia During the War*, Vol.XI, from the series *The Official History of Australia in the War of 1914-18*, edited by C.E.W.Bean, Angus and Robertson, Sydney, 1943.

Shirras, G.F., "The Public Finance and National Economy of Australia", Ch.V, pp.103-150, from Shirras, G.F., *Federal Finance in Peace and War*, Macmillan and Co.Ltd., London, 1944.

Shoup, C.S., *Ricardo on Taxation*, Columbia University Press, New York, 1960.

Smith, A., *An Inquiry into the Nature and Causes of the Wealth of Nations*, Encyclopaedia Britannica Inc., Chicago, 1952.

Studenski, P. and Kroos. H.E., *Financial History of the United States*, McGraw-Hill Book Company Inc., New York, 1952.

*Threats to Australia's Security: Their Nature and Probability*, Report by the Joint Committee on Foreign Affairs and Defence, Australian Parliament, Australian Government Publishing Service, Canberra, 1981.

Tuchman, B., *The March of Folly*, Abacus Books, New York, 1984.

Webber, C. and Wildavsky, A., *A History of Taxation and Expenditure in the Western World*, Simon and Schuster, New York, 1986.

Weida, W.J. and Gertcher, F.L., *The Political Economy of National Defense*, Westview Press, London, 1987.

## Other References and Sources

### (a) News

Time Magazine  
The Economist  
The Australian  
Australian Financial Review  
The Sun Herald  
The Sydney Morning Herald  
The Daily Telegraph

### (b) Specialist Publications

The Military Balance, the International Institute for Strategic Studies, London.  
Pacific Defence Reporter  
Janes Defence Weekly



(c) Original Sources

Commonwealth Parliamentary Debates

Budget Papers and Statements, Department of the Treasury

Ministerial Press Releases, Minister for Defence

Annual Reports, the Reserve Bank of Australia and the Australian  
Department of Defence